Fraud on the Market and the Substantive Theory of Class Actions

Zachary Alan Starr
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ACTIONS

ZACHARY ALAN STARR*

INTRODUCTION

To state a claim under rule 10b-5,1 promulgated under section
10(b) of the Securities Exchange Act of 1934,2 a plaintiff must
allege

(1) damages (2) caused by his reliance, (3) on defendants' misrep-
resentations or omissions of material facts, or on a scheme by de-
defendants to defraud, (4) made with an intent to deceive, manipu-
late, or defraud, (5) in connection with the purchase or sale of
securities, and (6) furthered by defendants' use of the mails or
any facility of a national securities exchange.3

* Member of the firm of Goodkind, Labaton & Rudoff. B.A. 1971, Colgate; M.A. 1976,
Brandeis; J.D. 1980, Hofstra University.
1 17 C.F.R. § 240.10b-5 (1990). Rule 10b-5 states:
It shall be unlawful for any person, directly or indirectly, by the use of any
means or instrumentality of interstate commerce, or of the mails or of any facility
of any national securities exchange,
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a
material fact necessary in order to make the statements made, in the light of the
circumstances under which they were made, not misleading,
or
(c) To engage in any act, practice, or course of business which operates or
would operate as a fraud or deceit upon any person, in connection with the
purchase or sale of any security.
Id.
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means or instrumentality of interstate commerce or of the mails, or of any facility
of any national securities exchange

. . . .
(b) To use or employ, in connection with the purchase or sale of any security
registered on a national securities exchange or any security not so registered, any
manipulative or deceptive device or contrivance in contravention of such rules and
regulations as the Commission may prescribe as necessary or appropriate in the
public interest or for the protection of investors.
Id.
lessness, as opposed to actual intent to deceive, may suffice to establish a defendant's liabil-

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The "fraud-on-the-market" theory has been used in rule 10b-5 litigation with regard to the second element to create a rebuttable presumption of reliance on a defendant's misrepresentations.

The fraud-on-the-market theory is based on the premise that the price of actively traded securities, or, more precisely, securities traded on efficient capital markets,\(^4\) reflects all relevant publicly available information.\(^5\) Consequently, relevant misrepresentations defraud investors who trade on efficient markets, regardless of whether the investors directly rely on the misrepresentations, because they unfairly affect the market price of securities.\(^6\)

Confronted with the plaintiff's need in a rule 10b-5 class action to demonstrate reliance on the misrepresentation, courts have presumed that investors rely on the market price of actively traded securities being validly set or an indication of the stock's intrinsic


See Peil v. Speiser, 806 F.2d 1154, 1160, 1161 n.10 (3d Cir. 1986); Ballan, 720 F. Supp. at 251. The so-called "efficient capital markets hypothesis" actually has three "forms":

[T]he weak form of the hypothesis holds that past price movements are incorporated in prices; the semi-strong form suggests that publicly-available information is reflected in prices; and the strong form posits that all information from whatever source is fully incorporated in prices. The empirical evidence to date (with some exceptions) appears to establish the validity of the weak and semi-strong versions but not the strong form of the efficient capital markets hypothesis.

Fischel, supra note 4, at 911; see Macey & Miller, Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory, 42 Stan. L. Rev. 1059, 1078-79 (1990) (contending that in Basic, the Supreme Court "implicitly applied the semi-strong form").

See Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975) ("purchaser on the stock exchanges may be either unaware of a specific false representation, or may not directly rely on it . . . whether he is aware of it or not, the price he pays reflects material misrepresentations"), cert. denied, 429 U.S. 816 (1976); see also Zlotnick v. Tie Communications, 836 F.2d 818, 822 (3d Cir. 1988) (to extent market price has been artificially inflated by misrepresentations, market price has "been infected by fraud"); Peil, 806 F.2d at 1160-61 ("misleading statements will . . . defraud purchasers of stock even if the purchasers do not directly rely on the misstatements [because] . . . [t]he misstatement may affect the price of the stock, and thus defraud purchasers who rely on the price").
Courts further presume, on the basis of the fraud-on-the-market theory, that investors indirectly rely on all representations that unfairly affect the market price. Use of the fraud-on-the-market theory in this manner was upheld by the United States Supreme Court in Basic Inc. v. Levinson.

Some courts that invoke the fraud-on-the-market presumption of reliance appear not to presume indirect reliance on the misrepresentation, but rather, substitute reliance on the integrity of the market for reliance on the misrepresentation. See, e.g., Peil, 806 F.2d at 1161 (“purchasers generally rely on the price of the stock as a reflection of its value”); Ballan, 720 F. Supp. at 251 (“investors rely on integrity of market”); Anderson v. Bank of the South, N.A., 118 F.R.D. 136, 143 (M.D. Fla. 1987) (“average investor “relies on the premise that the market price is validly set””). See generally Basic Inc. v. Levinson, 485 U.S. 224, 246-47 (1988) (“hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?” (quoting Schlanger v. Four-Phase Systems, Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982)). But see Basic, 485 U.S. at 255-56 (White, J., concurring in part, dissenting in part) (questioning whether investors rely on price as indication of “true value”). The presumption should appropriately be that purchasers rely on the price being “validly set,” rather than being an indication of the stock’s true value. See infra note 83.

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In Basic, the Court emphasized the importance of the “fraud-on-the-market presumption of reliance” for class action litigation. Specifically, the Court recognized that, in the absence of a presumption of reliance, each class member would individually have to prove reliance on the relevant misrepresentation, making the element of reliance an individual question which might overwhelm, or “predominate” over, common questions.\(^1\) Predomination of individual elements, in turn, precludes class certification by preventing the satisfaction of the class certification requirement that common elements of law and fact predominate over individual elements.\(^1\)\(^1\)

Following the adoption of the fraud-on-the-market presumption of reliance, defendants have sought to defeat class certification by rebutting the presumption of reliance. In cases involving efficient markets, this attempt has taken two general forms.\(^1\)\(^2\) Some


Basic, 485 U.S. at 242. At least one court has in fact stated that class certification in Rule 10b-5 class actions should be denied where reliance is an individual issue. Gibb v. Delta Drilling Co., 104 F.R.D. 59, 66 (N.D. Tex. 1984) (“As long as reliance remains an issue, it predominates over common questions of law or fact, thus precluding maintenance as a class action of plaintiffs’ claim under Section 10(b) and Rule 10b-5’’); \(^{10}\) see also Sanders v. Robinson Humphrey/Am. Express, Inc., 634 F. Supp. 1048, 1063 (N.D. Ga. 1986) (each class member must prove individual reliance on misrepresentations, making certification as class action “highly inappropriate”), cert. denied, 485 U.S. 959 (1988). More typically, Rule 10b-5 class actions are certified despite individual issues of reliance. See, e.g., Data Access Sys. Sec. Litig., 103 F.R.D. 130, 139, 142 (D.N.J. 1984) (if plaintiffs’ differing “modes of reliance” were allowed to defeat class certification, “there could never be a class action of securities purchasers”), rev’d on other grounds, 843 F.2d 1537 (3d Cir. 1988); Muth v. Dechert, Price & Rhoads, 70 F.R.D. 602, 607 (E.D. Pa. 1976) (despite individualized issues, class action appropriate where there is “crucial core allegation of a common course of conduct that yields predominant common questions”).

Although Rule 10b-5 class actions may thus be certified without resort to the fraud on the market presumption of reliance, the fraud-on-the-market theory in connection with the substantive theory of class actions nevertheless provides a more satisfactory framework for analyzing the reliance question in securities class actions.

See FED. R. CV. P. 23. Rule 23, in pertinent part, provides as follows:

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

. . . .

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members.

Id.

\(^{12}\) Defendants may also contend that the relevant security was not traded on an effi-
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defendants have contended that the plaintiff seeking to represent the class was not entitled to rely on the fraud-on-the-market presumption of reliance because that plaintiff had not considered the price of the security in making the relevant investment decision and consequently that the plaintiff could not be certified as the class representative. Other defendants have contended that the class as a whole was not entitled to the fraud-on-the-market presumption of reliance because the alleged misrepresentations did not in fact affect the market price of the relevant security.

In addition, some courts have suggested that proof of direct reliance on the misrepresentation and proof of indirect reliance by means of the fraud-on-the-market presumption of reliance are mutually exclusive alternatives. Thus, class members who relied di-
rectly on the misrepresentation are seen as different from, and perhaps in conflict with, class members who indirectly relied on the misrepresentation as a result of their reliance on the integrity of the market.\textsuperscript{16} Such conflicts could serve to preclude, or at least limit, a Rule 10b-5 class action.\textsuperscript{17}

Courts have also held that use of the fraud-on-the-market presumption of reliance “does not apply to . . . common law fraud claims.”\textsuperscript{18} According to such courts, state law claims for common-law fraud or negligent misrepresentation, require a showing of “actual and justifiable reliance on the alleged misrepresentations by each plaintiff.”\textsuperscript{19} The refusal to apply the fraud-on-the-market theory to state law claims, and the corresponding requirement that each class member individually prove the reliance element of a state law claim, often prevents class certification of such claims.\textsuperscript{20}

\textsuperscript{16} Berman, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,905 at 95,009. “[I]f it should later appear that plaintiff is not entitled to the fraud on the market presumption and the remaining plaintiffs are entitled to that presumption, then plaintiff may have a conflict with the remaining class members.” Id.

\textsuperscript{17} Among the requirements for class certification are that the class representative (i) have claims that are typical of the claims of the class (the “typicality requirement”), and (ii) will fairly and adequately protect the interests of the class (the “adequacy requirement”). Fed. R. Civ. P. 23(a). Where the claims of the class representative are determined to be significantly different from, or in conflict with, those of other class members, the court may determine that the typicality and adequacy requirements are not satisfied, and, therefore may deny class certification. See, e.g., Spivak v. Petro-Lewis Corp., 118 F.R.D. 504, 509 (D. Colo. 1987) (nontendering shareholders' claims were not typical of those of tendering shareholders and former could not adequately represent latter). Alternatively, the court may act under Rule 23(c)(4) to limit the class action to the particular claims of the class representative. Fed. R. Civ. P. 23(c)(4).


This Article focuses on the use of the fraud-on-the-market theory in the class action context. It is a primary contention that, in a class action, the fraud-on-the-market theory is best applied in connection with a substantive theory of class action suits. The substantive theory of class actions not only justifies application of the fraud-on-the-market theory in securities class actions, but provides the most useful theoretical framework for analyzing class certification issues arising from such application. Under the substantive theory of class actions, the fraud-on-the-market theory is not viewed as creating a rebuttable presumption of reliance, and proof of a fraud-on-the-market is not, strictly speaking, viewed as a substitute for proof of reliance on the misrepresentations. Rather, the fraud-on-the-market theory is viewed as providing a satisfactory and appropriate way of satisfying the element of reliance on a class-wide basis, in that proof of a fraud on the market is viewed as constituting, for the class as a whole, proof of reliance on the misrepresentation.

Part One of this Article describes the manner in which courts have used the fraud-on-the-market theory in connection with the reliance element in securities class actions under rule 10b-5 to create a rebuttable presumption of reliance. Part Two describes the substantive theory of class actions and analyzes the fraud-on-the-market theory with reference to such theory of class actions. It is contended that, in a class action, reliance on a misrepresentation may be established on a classwide basis by proving that the market price of a security was artificially inflated by the misrepresentation.\(^{21}\) Under the substantive theory of class actions, such class-wide proof of reliance is justified by the underlying policy objectives of a private action under rule 10b-5. Part Three demonstrates how difficulties that arise when the fraud-on-the-market theory is used to create a rebuttable presumption of reliance may be overcome when the fraud is used in the context of a substantive theory of class actions to prove reliance on a classwide basis. Part Four considers the fraud-on-the-market theory in the context of state law claims, and contends that the underlying policy objectives of fraud and negligent misrepresentation justify the use of class-wide proof of reliance for state law, as well as rule 10b-5, claims.

\(^{21}\) For convenience, this Article focuses on instances wherein misrepresentations artificially inflate the market price of a security. Parallel arguments apply where misrepresentations artificially deflate the market price of a security.
I. THE FRAUD-ON-THE-MARKET THEORY AND THE RELIANCE ELEMENT

The fraud-on-the-market theory hypothesizes that the price of actively traded securities of business entities reflects publicly available information about such entities. Thus, if the publicly available information is materially false or misleading, it will be reflected in the price of the relevant securities. More particularly, if publicly available information about a business entity is unduly optimistic, or if it fails to include material, adverse facts about the entity, the price of the entity’s securities will trade at a higher price than that at which they would have otherwise traded, i.e., the price will be “artificially inflated.”

Courts have used the fraud-on-the-market theory in connection with the reliance element in securities actions under rule 10b-5. In a rule 10b-5 action, the plaintiff must establish reliance on the alleged material misrepresentation. Courts consistently have held that, in circumstances in which the fraud-on-the-market theory is applicable, “proof of subjective reliance on particular misrepresentations is unnecessary to establish a Rule 10b-5 claim.” In these cases, although a purchaser may not be aware of or rely on a specific false representation about a business entity, the representation may nevertheless artificially inflate the price of the entity’s securities. Inflation generally results whenever investors purchase in reliance on the false information, since these additional purchases drive the price of the stock upward. Accordingly,

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22 Ballan v. Wilfred Am. Educ. Corp., 720 F. Supp. 241, 251 (E.D.N.Y. 1989) (result of misrepresentation is that price of securities will not reflect true value); see also Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986) (“In an open and developed market, the dissemination of material misrepresentations or withholding of material information typically affects the price of the stock”).


25 See id. (reliance of some market traders can cause inflation in stock price); see also Peil, 806 F.2d at 1162 (material misrepresentations or omissions likely to influence buyers and sellers and thus market). The market traders need not have relied directly on the false information, but indirectly through statements of securities analysts, brokers, or others. Grossman, 100 F.R.D. at 788-89. This type of indirect reliance should be distinguished from indirect reliance based on the fraud on the market theory. This Article includes the former
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so long as the deception has influenced enough individuals to have affected the price, any investor who has, in reaching his investment decision, relied on the price having been validly set, that is, who relied on the "integrity of the market," is presumed to have indirectly relied on the misrepresentation. As explained in Blackie v. Barrack:26

A purchaser on the stock exchanges may be either unaware of a specific false representation, or may not directly rely on it; he may purchase because of a favorable price trend, price earnings ratio, or some other factor. Nevertheless, he relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price—whether he is aware of it or not, the price he pays reflects material misrepresentations.27

Use of the fraud-on-the-market theory in connection with the reliance requirement of a rule 10b-5 action has occurred primarily, if not exclusively, in the class action context. Courts have recognized that if each class member individually had to establish subjective or direct reliance on the material misrepresentation, the utility of the class action device, and thus the efficiency of the federal securities laws, would be seriously undermined.28 Individualized proof of reliance might prevent satisfaction of the class certification requirement that common issues predominate, and if class certification were denied, there would be no viable remedy for violations of the federal securities laws.29

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26 See generally Escott v. Barchris Constr. Corp., 340 F.2d 731, 733 (2d Cir.) (emphasizing importance of class action device to vindicate securities law claims of small stockholders), cert. denied, 382 U.S. 816 (1965); Peil, 86 F.R.D. at 373 ("to allow various secondary issues . . . to destroy the institution of a class action would render the rule an impotent tool for private enforcement of the federal securities laws"); cert. denied, 474 U.S. 903 (1985); Ramsey v. Arata, 406 F. Supp. 435, 441 (N.D. Tex. 1975) ("[t]o prohibit class treatment in a securities case would do violence to the remedial nature of the securities acts"); 3 L. Loss, SECURITIES REGULATION 1819 (2d ed. 1961) (effectiveness of federal remedies largely dependent on class action device); Note, supra note 28, at 593 (to require proof of actual reliance "would present an enormous and unwarranted practical barrier to recovery"); Note, The
Accordingly, courts have long held that in a securities class action involving an efficient market, the fraud-on-the-market theory justifies a presumption of reliance. In this manner the reliance element is prevented from interfering with class certification.

In Basic, the United States Supreme Court upheld the use of the fraud-on-the-market theory. The Court held that, in a securities action under rule 10b-5, a fraud on the market, properly alleged, establishes a rebuttable presumption of reliance. In justifying the fraud-on-the-market presumption of reliance, the Court did not distinguish its use in a class action from its use in an individual lawsuit. However, Basic was in fact a class action and the Court recognized that requiring individualized proof of reliance would have effectively prevented plaintiffs from obtaining class certification.

The presumption of reliance created by the fraud-on-the-market is "rebuttable." Proof that an individual plaintiff did not rely on the integrity of the market price of the relevant security, or that the market price did not reflect the misstatement, is sufficient to rebut the presumption.


Basic, 485 U.S. at 247. "Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed." Id.

Some commentators have suggested that the creation of a presumption of reliance, in effect, eliminates the need to prove the element of reliance, and thus, arguably, contravenes the Supreme Court's authority to prescribe rules of procedure. See Black, supra note 9, at 440 n.21; see also Ross, Rule 23(b) Class Actions—A Matter of "Practice and Procedure" or "Substantive Right"?, 27 Emory L.J. 247, 253-56 (1978) (Rule 23 as violative of the Rules Enabling Act); Developments in the Law—Class Actions, 89 Harv. L. Rev. 1318, 1358 (1976) (Rules Enabling Act "does not mandate that federal courts ignore substantive considerations in making procedural decisions). But see Comment, supra note 9, at 281-82 (procedural rule affecting substantive rights is constitutional if the interference is merely incidental and rule is reasonably necessary to maintain orderly system of rules).

When the fraud on the market theory is not used to create a presumption of reliance but as a means of proving reliance on a classwide basis so as to best achieve the underlying policy goals of a Rule 10b-5 action, see infra text accompanying notes 37-51, there can be no valid charge that an element of a Rule 10b-5 cause of action has been eliminated. See Note, Class Action in a Products Liability Context: The Predomination Requirement and Cause-In-Fact, 7 Hofstra L. Rev. 859, 885 n.127 (1979) [hereinafter Note, Class Action].

Basic, 485 U.S. at 250.

See supra note 28 and accompanying text.

As stated in Basic:

Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair
In the class action context, the use of the fraud-on-the-market theory to establish a rebuttable presumption of reliance has, to a large extent, served merely to shift the focus of defendants’ objections to class certification. Before the development and general acceptance of the fraud-on-the-market’s presumption of reliance, defendants often opposed class certification on the ground that each class member had to prove reliance individually; therefore, it was argued, individual issues of law and fact predominated over common issues. Now in a fraud-on-the-market case, defendants frequently oppose class certification on the ground that the class representative did not rely on the integrity of the market price in purchasing the relevant security, and thus cannot use the fraud-on-the-market theory available to other class members. In essence, this new attack reestablishes the reliance requirement as an individual issue. Instead of forcing each class member individually to establish subjective or direct reliance on the misrepresentation, class members are forced individually to establish reliance on the integrity of the market. In addition, defendants have argued that the fraud-on-the-market theory may not be used to satisfy the predomination requirement where accurate information was available in the market from third parties.

These new objections to class certification in a securities action are inappropriate. Their inappropriateness is best demonstrated by examples of the sorts of facts that would be sufficient to rebut the presumption of reliance. For example, if petitioners could show that the “market makers” were privy to the truth about the merger discussions here with Combustion, and thus that the market price would not have been affected by their misrepresentations, the causal connection could be broken: the basis for finding that the fraud had been transmitted through market price would be gone. Similarly, if, despite petitioners’ allegedly fraudulent attempt to manipulate market price, news of the merger discussions credibly entered the market and dissipated the effects of the misstatements, those who traded Basic shares after the corrective statements would have no direct or indirect connection with the fraud. Petitioners also could rebut the presumption of reliance as to plaintiffs who would have divested themselves of their Basic shares without relying on the integrity of the market. For example, a plaintiff who believed that Basic’s statements were false and that Basic was indeed engaged in merger discussions, and who consequently believed that Basic stock was artificially underpriced, but sold his shares nevertheless because of other unrelated concerns, e.g., potential antitrust problems, or political pressures to divest from shares of certain businesses, could not be said to have relied on the integrity of a price he knew had been manipulated.

Basic, 485 U.S. at 248-49; see also Peil v. Speiser, 806 F.2d 1154, 1161-63 (3d Cir. 1986) (explaining what will and will not rebut presumption).

See supra note 13.

See supra note 14.
demonstrated when the fraud-on-the-market theory is viewed in the context of a general theory of the class action suit. Accordingly, before the new objections to class certification may be most fruitfully analyzed, it is first necessary to discuss a general theory of class actions.

II. THE FRAUD-ON-THE-MARKET THEORY OF CLASS ACTIONS AND THE SUBSTANTIVE THEORY OF CLASS ACTIONS

Of the general, commonly advanced theories of class actions, a compelling argument has been made that the substantive theory provides the most satisfactory approach to the contemporary class action suit.\(^{37}\)

The substantive theory maintains as its basic premise that the most significant function of contemporary class actions is to open courts to claims not ordinarily litigated because they are not economically feasible. This function is achieved by “aggregating substantially similar claims, thereby prorating the cost of litigation among numerous litigants.” The increased access to courts made possible by the class suit is itself justified, according to the substantive approach, because it promotes full realization of substantive policy objectives underlying the claims sought to be enforced in the class suit.\(^{38}\)

From the perspective of the substantive theory, the rule 23 requirement for class certification that common elements of law and fact predominate over individual elements is satisfied if class certification furthers the remedial and structural policies underlying the substantive law upon which the action is based.\(^{39}\) Remedial policies are furthered when the overall purposes of the law authorizing the cause of action are best achieved through class certifica-

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\(^{37}\) See Developments in the Law—Class Actions, supra note 31, at 1329-72 (isolating and comparing three theories of class actions).

\(^{38}\) Note, Class Action, supra note 31, at 864; see Korn v. Franchard Corp., 456 F.2d 1206, 1214 (2d Cir. 1972) (one chief goal of Rule 23 is to provide means of redress to plaintiffs with small individual claims); Escott v. Barchris Constr. Corp., 340 F.2d 731, 733 (2d Cir.) (class action necessary device for vindicating claims that, individually, would be too small to warrant litigation), cert. denied, 382 U.S. 816 (1965); Dolgow v. Anderson, 43 F.R.D. 472, 484-85 (E.D.N.Y. 1968) (class action proper “where those who have allegedly been injured ‘are in a poor position to seek legal redress, either because they do not know enough or because such redress is disproportionately expensive’”); Kalven & Rosenfield, The Contemporary Function of the Class Suit, 8 U. Chi. L. Rev. 684, 692 (1941) (class suit as effective for group redress as derivative suit for shareholders).

\(^{39}\) Note, Class Action, supra note 31, at 864-65.
tion. Structural policies are furthered when the elements of the cause of action are all capable of being proven by general modes of proof.\textsuperscript{40} If full compatibility of class action procedures with the remedial and structural policies of the underlying cause of action does not exist (because, for example, some elements cannot be proven by general modes of proof), the predomination requirement may nevertheless be satisfied if class certification will achieve a fair balance among the social values sought to be advanced by the substantive law on which the cause of action is based.\textsuperscript{41}

With reference to a private cause of action under rule 10b-5, structural policies are not fully promoted by class certification if the reliance element may be established only by individual, rather than general, modes of proof. Conversely, if the reliance element may be established by general modes of proof, the structural policies underlying this element are indeed furthered by class certification. The fraud-on-the-market theory provides a means for a general mode of proving reliance in a rule 10b-5 action. The appropriateness of employing such means, however, depends on whether the underlying remedial policy objectives of a cause of action under rule 10b-5 will, on balance, be advanced.\textsuperscript{42}

The major remedial policy objectives of a rule 10b-5 private cause of action are to protect the integrity of the marketplace by deterring the artificial inflation of securities prices caused by material misrepresentations or omissions,\textsuperscript{43} and to compensate the victims of securities fraud.\textsuperscript{44} These objectives are achieved by award-

\textsuperscript{40} See id. at 865. A “general mode of proof” refers to proving an element of a cause of action in a manner applicable to the entire class. An “individual mode of proof” refers to proving an element of a cause of action in a manner applicable only to an individual member of the class. Id.

\textsuperscript{41} Id. at 865-66.

\textsuperscript{42} See id. at 873.

\textsuperscript{43} Basic, 485 U.S. at 245-46 (policy underlying 1934 Act was to facilitate investor reliance on integrity of market); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (“fundamental purpose . . . was to substitute a philosophy of full disclosure for the philosophy of caveat emptor”); Blackie, 524 F.2d at 907 (1934 Act and Rule 10b-5 designed to keep securities markets “free from fraud”).

\textsuperscript{44} See Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986) (in enacting the 1934 Act, Congress intended, not only to compensate injured investors, but to deter fraudulent and manipulative practices in securities market and to ensure full disclosure of material information); Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) (in inferring private right of action for violations of Rule 10b-5, court concluded that Congress intended original statute to be interpreted as providing for civil suits “for money damages”); A. Jacobs, Litigation and Practice Under Rule 10b-5, § 260.03[a], at 11-22 (2d ed. 1991) (major principles guiding judges in awarding 10b-5 damages are deterrence and compensa-
ing damages to victims of rule 10b-5 violations. The damages awarded, however, should not result in “overcompensation” and “overdeterrence.” On the other hand, “underdeterrence” of wrongdoing and “undercompensation” of victims is, clearly, also to be avoided. In order to achieve optimal deterrence, the allocation of costs to the wrongdoer should be accurate—only those damages actually caused by the fraud should be allocated to the wrongdoer. The function of the reliance element is to achieve such an accurate allocation of costs.

Arguably, an accurate allocation of costs is achieved when each individual plaintiff demonstrates a causal link between his or her loss and the defendant’s fraud by proving subjective, direct reliance. However, the allocational goal of the reliance element can also be achieved on a classwide basis by use of the general mode of proof provided by the fraud-on-the-market theory. On the basis of the fraud-on-the-market theory, the defendants’ misrepresentations are acknowledged to have affected the price of the relevant

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4 See Huddleston v. Herman & MacLean, 640 F.2d 534, 559 (5th Cir. 1981) (10b-5 plaintiff may only recover actual, and not punitive, damages).

45 Randall, 478 U.S. at 664 (deterrence ill served by limiting plaintiffs to recovering their “net economic” loss). See generally A. Jacobs, supra note 44.

46 Cf. Note, Class Action, supra note 31, at 878 (allocation accurate when only costs relevant to choice between injury and safety are allocated to activity in question).

47 Basic, 485 U.S. at 243 (reliance provides “causal connection” between defendant's acts and plaintiff's loss); Peil v. Speiser, 806 F.2d 1154, 1161 n.11 (3d Cir. 1986) (reliance is one part of “ubiquitous requirement” of causal relationship to defendant's acts); Rosenberg v. Digilla, 648 F. Supp. 40, 43 (E.D. Pa. 1985) (reliance provides nexus between defendant's conduct and plaintiff's injury); Blackie, 524 F.2d at 906 (proof of reliance needed to show “causal connection” between defendant's wrongdoing and plaintiff's injury); see Note, Class Action, supra note 31 at 873, 877-78 (reliance surrogate for “cause-in-fact element”).

48 It could be argued, however, that because the modern securities market differs dramatically from the face-to-face transactions of early fraud cases, Basic, 485 U.S. at 243-44, an investor bringing an individual action need not establish his own reliance as a causal link between the misrepresentation and the injury. As long as others relied on the false information, a causal link exists. Cf. Dann v. Studebaker, 288 F.2d 201, 209 (6th Cir. 1961) (stockholder not relying on misleading proxy statement had standing to sue under 1934 Act because he could suffer “equally damaging injury” to corporate interests if other stockholders were deceived); accord Sandberg v. Virginia Bankshares, Inc., 891 F.2d 1112, 1119 (4th Cir. 1989), cert. denied, 110 S. Ct. 1921 (1991); Cowin v. Bresler, 741 F.2d 410, 427 (D.C. Cir. 1984); Yamamoto v. Omiya, 564 F.2d 1319, 1325-26. A stockholder's injury due to deceptive proxy solicitation may result, “not from the deceit practiced on him alone, but rather from the deceit practiced on the stockholders as a group.” J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).
Therefore, the costs allocable to the defendant may be based on the impact such fraud had on the price of the relevant stock. In other words, in those circumstances where a defendant's misrepresentations have artificially inflated the price of a security actively traded on the market, a causal link between the misrepresentation and the loss sustained by the class of investors who purchased the security during the relevant time period is established.51

Viewed in this way, the use of the fraud-on-the-market theory in connection with the reliance element in a securities class action under Rule 10b-5 establishes the element of reliance for the class as a whole by a general mode of proof. Once it is proven that the market price of a security was artificially inflated by the misrepresentation, reliance on the misrepresentation by the relevant class of investors is established. The market price of the security could not have been artificially inflated unless at least some members of the investment community directly relied on the misinformation.52 Indeed, the amount by which the security was artificially inflated (multiplied by the appropriate number of shares traded) should typically constitute the precise amount of damages caused by the misrepresentation. Thus, it can be argued that use of this general mode of proving reliance provides a way of achieving the most accurate allocation of costs, and thus, the most nearly optimal deterrence.

In any event, the allocation of costs is likely to be less accurate, and the deterrence objective less effective, without the general mode of proving reliance permitted by the fraud-on-the-market theory. In any securities fraud occurring in the market, most investors sustain losses too minimal to warrant the very great expense of an individual suit.53 Thus, in the absence of class certifica-

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50 See supra notes 6, 25-27 and accompanying text.
51 See generally Blackie, 524 F.2d at 906 (“materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case”); Rosenberg, 648 F. Supp. at 43 (reliance on market's integrity adequately demonstrates causal nexus); Reeder v. Mastercraft Elecs. Corp., 363 F. Supp. 574, 581 (S.D.N.Y. 1973) (plaintiffs would not have purchased at artificially inflated price absent misrepresentation); In re Memorex Sec. Cases, 61 F.R.D. 88, 101 (N.D. Cal. 1973) (same); Note, supra note 28, at 593 (“proof that the deception influenced only enough individuals to have produced the adverse effect will establish causation”); Note, Class Action, supra note 31, at 873-74 (same).
52 See supra note 25 and accompanying text.
tion, all remedial policy goals of a private action under rule 10b-5 may be frustrated; and, in the absence of a general mode of proving reliance, such actions may be denied class certification.

Conversely, use of the fraud-on-the-market theory to prove reliance on a class-wide basis will most fully satisfy all policy goals at stake. By enabling class certification, and thus enabling investors to bring suit, costs may be allocated to the defendants for their misrepresentations, investors whose damages were caused by the misrepresentations may be compensated, and the integrity of the market may be protected. Use of such class-wide proof of reliance, however, may result in a less than complete satisfaction of the compensation goal. Some investors who did not in any way rely on the misrepresentations (and whose damages were not, therefore, caused by reliance on the misrepresentations) may nevertheless be compensated. However, the compensation goal is less frustrated by compensation of some individuals who did not in any way rely on the misrepresentations than it is by the complete denial of compensation to those individuals who did in fact rely.

Under this "substantive compatibility analysis," the use of the fraud-on-the-market theory’s general mode of proving reliance enables courts, to the greatest extent possible to realize the policy goals at stake. Once the fraud-on-the-market theory is understood in light of the substantive theory of class actions to merely

complexity of securities laws makes litigation expensive, "individual suits would not involve sufficient losses to justify costs").

Id. at 364 (discussing necessity of class action device to correct "many actionable wrongs" and recompense "affected persons").

If class certification is granted, despite the need for individualized proof of reliance, the administrative costs of separate hearings on the issue of reliance would, in most situations, be prohibitive. Individualized proof of reliance would thus fail to satisfy the goal of compensation to the same extent as would a general mode of proof. See Note, Class Action, supra note 31, at 886-88 (where administrative costs so deplete the recovery fund that relief to class members would be insignificant, compensation goal is thwarted and substantive fairness of class suit is correspondingly reduced).

Note, supra note 28, at 590. It is unlikely, however, that there will be very many investors who did not rely on the integrity of the market. Basic, 485 U.S. at 246-47.

See Blackie, 524 F.2d at 907 n.22 (remedial purposes of statute served "only by allowing an overinclusive recovery to a defrauded class if the unavailability of the class device renders the alternative a grossly underinclusive recovery"); see also Note, supra note 28, at 590-91 (in nondisclosure cases, "risk of overcompensation . . . seems likely to be less significant than the risk of undercompensation that would arise if proof of reliance were required"); cf. Note, Class Action, supra note 31, at 882 (in products liability context, risk of overdeterrence less significant than risk of underdeterrence).

Cf. Blackie, 524 F.2d at 907 n.22 (if right to rebuttal threatens subversion of class action, it may be eliminated to effectuate purposes of statute).
provide a means of proving reliance on a class-wide basis, courts
can more properly analyze various issues raised by allegations of a
fraud on the market and by the creation of a fraud-on-the-market
presumption of reliance. It is these issues that this Article next
addresses.

III. ISSUES RAISED BY THE FRAUD-ON-THE-MARKET THEORY

A. Rebutting the Presumption of Reliance

Viewing the fraud-on-the-market theory as a vehicle for
adopting a rebuttable presumption of reliance on a misrepr-}

eresentation, rather than as a vehicle for proving reliance on a class-wide
basis, leaves open the possibility that numerous individual issues
of reliance will have to be tried in a rule 10b-5 class action. De-
fendants may now seek to rebut the presumption of reliance by
proving that each class member bought the relevant security with-
out relying on the integrity of the market. Viewed from such a
conceptual framework, therefore, individual issues of reliance re-
main and the very raison d'etre for the fraud-on-the-market the-
ory in the securities class action context is vitiated. The pre-
sumption of reliance endorsed by the Supreme Court in Basic
merely shifts the focus of attention from whether an individual re-
lied on the misrepresentation to whether an individual relied on
the "integrity of the market." Reliance on the misrepresentation is
presumed only for those who relied on the "integrity of the mar-
ket"—that is, those investors who traded the relevant stock in reli-
ance on the integrity of the price set by the market. In keeping
with this shift in focus, it is now commonplace for defendants to
attack class certification by attempting to rebut the fraud-on-the-

69 Basic, 485 U.S. at 248; see supra note 34; see also Berman v. Entertainment Mktg.,
18, 1990) (raising question of how many members of plaintiff class must be shown not to
have relied on integrity of market "before the action may no longer be maintained as a
class"). More typically, defendants seek to rebut the presumption of reliance only for the
named plaintiff. If the named plaintiff is shown to be an unsatisfactory class representative
because he or she is not entitled to the presumption of reliance, and if no satisfactory class
member comes forward, defendants will be able to defeat a motion for class certification.
60 But see Basic, 485 U.S. at 256 n.7 (White, J., concurring in part, dissenting in part)
(rebuttal of presumption of reliance "is virtually impossible in all but the most extraordi-
ary case"); Blackie, 524 F.2d at 906 n.22 ("we doubt that a defendant would be able to
prove in many instances to a jury's satisfaction that a plaintiff was indifferent to a material
fraud").
market presumption of reliance of a plaintiff on the ground that the plaintiff did not rely on the "integrity of the market."\footnote{See supra note 13 and accompanying text.}

However, once it is recognized that, under the substantive theory of class actions, the fraud on the market theory is a vehicle for establishing reliance on a class-wide basis, all individual issues of reliance are eliminated. Whether the class representative, or any particular member of the class, individually relied on the misrepresentation or on the integrity of the market is, and should be, irrelevant. The sole issue becomes whether the misrepresentation affected the price of the security.

In sum, the fraud-on-the-market theory should not be used to create a rebuttable presumption of reliance, but should be used as a means of proving reliance on a class-wide basis. The usefulness of the fraud-on-the-market theory in a class action context is not to shift the focus of attention from reliance on the misrepresentation to reliance on the price of the security or the integrity of the market. Rather, the theory, in such a context, is best used to focus attention on the fact that any adverse impact on the market price of a security resulting from a misrepresentation demonstrates that the investment community as a whole directly relied on the misrepresentation. The requisite causal connection between the misrepresentation and injury to the class can thus be established for the class as a whole.

B. Choosing Between Reliance on the Misrepresentation and Fraud on the Market

Courts have questioned whether a plaintiff who directly relies on alleged misrepresentations is also entitled to the fraud-on-the-market presumption.\footnote{See supra note 15 and accompanying text.} A plaintiff must therefore choose between the fraud on the market theory and a contention that statements on which he directly relied were misleading. The two choices are deemed to be "logically inconsistent."\footnote{See Ballan v. Wilfred Am. Educ. Corp., 720 F. Supp. 241, 251 (E.D.N.Y. 1989).}

Moreover, if the fraud-on-the-market presumption of reliance is seen to be in conflict with direct reliance on the misrepresentations, a plaintiff in a class action who is not entitled to the fraud-on-the-market presumption may be deemed unable to represent a class which includes members who are entitled to rely on the pre-
sumption. Therefore, a claim of fraud on the market, alleged to facilitate class certification, could have the unintended result of preventing class certification.

This anomaly is eliminated if the fraud on the market theory is understood in relation to the substantive theory of class actions. In particular, if the alleged fraud on the market is seen solely as a means of proving reliance on a class-wide basis, then the dichotomy between direct reliance by some members of the class and indirect reliance by other members of the class can be eliminated. Properly viewed, there is no conflict between members who directly relied on a misrepresentation and class members who indirectly relied on the misrepresentation through their reliance on the integrity of the market. Rather, all class members collectively prove reliance on the misrepresentation by proving that it artificially inflated the price of the relevant stock.

C. Proof of a Fraud on the Market as a Precondition for Use of a Rebuttable Presumption of Reliance

In Basic, the Supreme Court held that the presumption of reliance created by the fraud on the market theory could be rebutted, not only by proof that an individual plaintiff did not rely on the integrity of the market price, but also by proof that the misstatement did not in fact affect the market price of the relevant security. This holding reflects the notion that if a misstatement did not affect the market price of the relevant security, it may be reasonably inferred that the investment community as a whole did not rely on the misstatement.

Defendants have argued that where the predominance requirement of rule 23 is satisfied by resort to the fraud on the market presumption of reliance, class certification may be denied if the alleged misrepresentations are shown to have been made during a time when accurate information was available to the investment community from publicly available sources. If accurate information were available, it is contended, that there was no fraud on the market and, therefore, that the class should not be permitted to

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64 See supra notes 16-17 and accompanying text. But see In re Data Access Systems Sec. Litig., 103 F.R.D. 130, 139 & 142 (D.N.J. 1984) (factual differences in reliance insufficient to defeat class certification), rev'd on other grounds, 843 F.2d 1537 (3d Cir. 1988).
65 See supra note 34.
66 See supra note 14.
invoke the fraud-on-the-market presumption of reliance to obtain class certification.

This argument, though perhaps appealing if the fraud on the market theory is understood in terms of creating a presumption of reliance, loses all its force when the fraud-on-the-market theory is viewed as providing a way of proving reliance on a class-wide basis. When seen in connection with class-wide proof of reliance, demonstrating that a fraud on the market occurred becomes a substantive matter for trial rather than a precondition for entitlement to a presumption.

At least one court has in fact refused, on a motion for class certification, to consider what weight to accord “curative information” available in the market on the ground that such evidence is not relevant at the class certification stage, but should be left to the fact finder at trial. Courts have also ruled that whether there has been a fraud on the market is a question which applies to all class members and, thus, is itself a common question going to the merits of the case.

IV. FRAUD-ON-THE-MARKET THEORY IN THE CONTEXT OF STATE LAW CLAIMS

Until recently, only federal courts have considered the applicability of the fraud on the market theory to state law securities claims for fraud or negligent misrepresentation. In each instance, the state law claims were pendent to claims under the federal securities laws. Typically, federal courts analyzed the problem as requiring an initial determination of whether the fraud on the market theory had been adopted by the relevant state court.

Courts that have explicitly ruled on the question have found that the relevant state court had not adopted the fraud-on-the-market theory. Often this finding is conclusive; it is held that,
since the relevant state court had not adopted the fraud-on-the-market theory, the theory is “not available” for use with state law claims. The element of reliance is, therefore, an individual question.\textsuperscript{70} Other courts, without explicitly finding that the theory had not been adopted, have concluded that pendent state law claims require individual proof of reliance.\textsuperscript{71}

Federal courts, holding that the element of reliance in pendent state law claims for fraud and negligent misrepresentation is an individual question, have, in some cases, concluded that individual questions of reliance preclude class certification of the state law claims.\textsuperscript{72} In other cases, however, courts have understood that the presence of such individual questions does not mean that individ-


\textsuperscript{72} See supra note 10.
ual questions of law or fact predominate. The latter courts have, accordingly, permitted class certification of the state law claims.\textsuperscript{73} Many federal courts go beyond a simple determination that the relevant state court had not adopted the fraud on the market theory. They additionally have considered whether the relevant state court \textit{would} adopt the fraud-on-the-market theory.\textsuperscript{74} This second step determination has resulted in conflicting findings. Thus, for example, some federal courts have suggested that California state courts would apply the fraud-on-the-market theory.\textsuperscript{75} Other federal courts have found the opposite.\textsuperscript{76}

Recently, the Court of Appeals of California, Second Appellate District, in \textit{Mirkin v. Wasserman},\textsuperscript{77} considered the applicability of the fraud-on-the-market theory to state law claims in a securities class action; it concluded that the fraud-on-the-market presumption of reliance does not apply under California law for fraud and deceit, negligent misrepresentation, or violation of section 1507 of California's Corporations Code. In upholding the dismissal of the securities class action brought under such California law, the \textit{Mirkin} Court stressed that "reliance is a common element required under each cause of action for fraud and deceit, negligent misrepresentation, or violation of Section 1507."\textsuperscript{78} The court refused to permit the element of reliance in such state law causes of action to be established by employing the fraud-on-the-market theory: "While federal courts apply the fraud-on-the-market theory in rule 10b-5 actions, the considerations which apply there do not control fraud and misrepresentation causes of action based on California law."\textsuperscript{79}

\textsuperscript{73} See supra note 11.

Still other courts, without determining what the state courts would do, choose to adopt the fraud on the market presumption of reliance for state law claims so long as the relevant state court has not forbid its use. Ramtek Sec. Litig., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,483, at 97,519-20 (N.D. Cal. Sept. 7, 1990); \textit{Minpeco}, 718 F. Supp. at 176.

\textsuperscript{75} \textit{MDC Holdings}, 754 F. Supp. at 883; \textit{Ramtek Sec. Litig.}, 95,483, at 97,520; \textit{In re ZZZZ Best Sec. Litig.}, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,485, at 93,087-88 (C.D. Cal. May 25, 1989), ("that the 'fraud-on-the-market' theory has not been directly utilized in California to date does not imply that it is contrary to California law").


\textsuperscript{77} \textit{227 Cal. App. 3d 1537, 278 Cal. Rptr. 729 (1991).}

\textsuperscript{78} \textit{Mirkin}, 278 Cal. Rptr. at 733.

\textsuperscript{79} Id. at 738.
The *Mirkin* Court first distinguished application of the fraud-on-the-market theory in Rule 10b-5 class actions from its application in securities class actions under state law on the ground that the purpose of the federal securities laws is "to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry." Then, the *Mirkin* Court found that adoption of the fraud-on-the-market theory to state law causes of action would "eviscerate[ ] the reliance requirement" of such causes of action. According to Judge Ortega, who authored the opinion, the fraud-on-the-market theory, if adopted, "would eliminate California's reliance requirement and thus work a change in our substantive law." The court was not impressed with the plaintiffs' argument that refusal to adopt the fraud-on-the-market theory would enable defendants to escape liability for fraud. "Abhor[ance of] the type of misconduct alleged in the complaint," wrote Judge Ortega, was not "justification for obliterating the reliance requirement from California law."

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80 Id. at 741; see Consolidated Capital, [1990 Transfer Binder] Fed. Sec. L. Rep. ¶ 95,238 (Supreme Court's dicta, that Rule 10b-5 actions add to protections of common law fraud, used to justify conclusion that latter require actual reliance). But see Minpeco, S.A. v. Hunt, 718 F. Supp. 165, 176 (simply because Supreme Court dicta states that federal securities laws "add to the protections of common law fraud" does not mean that common-law fraud cannot encompass actions based on fraud on the market); see also In re Activision Sec. Litig., 621 F. Supp. 415, 431 (N.D. Cal. 1985) (because similarities between Rule 10b-5 actions and common law fraud outnumber differences, class certification of pendent state law claims permitted).

81 *Mirkin*, 278 Cal. Rptr. at 743.

82 Id. at 744.

83 Id. at 745. Ortega's belief that the fraud on the market presumption would obliterate the reliance requirement from California law was greatly influenced by Justice White's concurring and dissenting opinion in *Basic*. Id. at 742-43 (expressing "uncertainty over the validity of the efficient market thesis which underlies the fraud on the market theory"). According to Justice White, quoted at length by Judge Ortega, even if investors, in buying and selling securities, rely on the price of the securities, investors do not always presume that a security's price is a reflection of the security's "true value". *Id.* at 742 (quoting *Basic*, 485 U.S. at 255-57).

The objections to the fraud on the market theory raised by Justice White were found by Judge Ortega to be "weighty" and "persuasive in arguing against its application here." *Id.* Thus, it is significant that, as one commentator has stated, the points raised in *Basic* by Justice White "are correct but have nothing to do with the fraud on the market theory." *Fischel, supra* note 4, at 920.

The theory does not posit that there is some "true value" of an asset other than its price. On the contrary, the theory assumes that the market price is the best indicia of value which makes it all the more important that this price not be distorted by fraudulent information.

*Id.*

The presumption of reliance based on the fraud-on-the-market theory does not assume
The decisions in *Mirkin*, as well as the numerous federal court decisions involving application of the fraud-on-the-market presumption of reliance to state law claims, fail to consider the fraud-on-the-market theory in connection with a substantive theory of class actions. When so considered, it can be seen that (i) use of the fraud-on-the-market theory by state courts would not "obliterate" the reliance requirement of state law causes of action, and (ii) federal courts may employ the fraud-on-the-market theory for pendent state law claims regardless of whether the relevant state court has done so.

Under the substantive theory of class actions, the fraud on the market theory is not employed as an alternative to proof of reliance. Rather, it is used to satisfy the element of reliance on a class-wide basis. Thus, the reliance element is clearly not "obliterated." Moreover, as in rule 10b-5 cases, the class-wide proof of reliance is available, under the substantive theory of class actions, if and only if its use furthers the underlying policy goals of the relevant cause of action. The remedial policy objectives of state law causes of action for fraud and negligent misrepresentation are substantially the same as the remedial policy objectives of a rule 10b-5 cause of action; and the reliance element serves substantially the same purpose in such state law causes of action as in a rule 10b-5 cause of action. Therefore, the analysis which justifies use of the fraud-

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64 See Rosenblum v. Adler, 261 A.2d 138, 153 (1983) (allowing injured party to recover damages from independent auditor's negligent misrepresentation shifts loss from innocent creditor or investor to wrongdoer thereby deterring instances in which liability would ensue); Wiener, Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation, 20 S. Diego L. Rev. 233, 260 (1983) (imposing liability on accountant for negligent misrepresentation serves "dual functions of compensation for injury and deterrence of negligent conduct"). See generally W. Prosser, The Law of Torts, §§ 2 & 4, at 6 & 23 (4th ed. 1971). Tort law concerns itself with the allocation of losses arising out of human activities; courts consider the need not only to compensate the victim, but also to admonish and deter the wrongdoer. See id.

65 See W. Prosser, supra note 84, § 108, at 714 (reliance necessary to establish "causal connection between the wrongful conduct and the resulting damage"). See generally Note,
on-the-market theory to prove reliance on class-wide basis in rule 10b-5 cases, applies solely to cases involving only state law causes of action.

The classwide proof of reliance permitted by the fraud-on-the-market theory, and justified by the substantive theory of class actions, remains entirely a procedural mechanism. Use of a general mode of proof affects no substantive right. Therefore, federal courts may employ the fraud on the market theory to permit classwide proof of reliance in pendent state law claims regardless of whether the relevant state court has specifically adopted the fraud-on-the-market theory.

V. CONCLUSION

One of the elements of a private cause of action under rule 10b-5 is reliance. Courts have recognized that to permit individual issues of reliance to defeat class certification in a class action under rule 10b-5 would frustrate private enforcement of the federal securities laws. Accordingly, in order to prevent individual issues of reliance from precluding class certification, courts have used the fraud-on-the-market theory to create a rebuttable presumption of

Class Action, supra note 31, at 873-77.


If rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that bona fide complaints be carried to an adjudication on the merits. Rule 23(b), like the other civil rules, was written to further, not defeat, the ends of justice.

Id.

Moreover, principles of judicial economy require that pendent state law claims arising out of the same wrongdoing as federal securities law claims be litigated in a single forum. See In re Activision Sec. Litig., 621 F. Supp. 415, 431 (N.D. Cal. 1985) (class treatment of both federal and state claims will permit efficient presentation of proof on overlapping issues); In re Victor Tech. Sec. Litig., 102 F.R.D. 53, 59 (N.D. Cal. 1984) (individual questions for state common law claims did not predominate because some proof to be introduced in federal securities law claims will be relevant to state law claims).
reliance.

Unfortunately, this rebuttable presumption has not fully prevented defendants from returning to the issue of reliance in an effort to defeat class certification. Among other tactics, defendants have contended either that the plaintiff is not entitled to invoke the fraud-on-the-market presumption of reliance because the plaintiff did not rely on the integrity of the market, or that the class as a whole is not entitled to invoke the fraud on the market presumption of reliance because accurate information was available in the market. Moreover, some courts have indicated a willingness to limit classes in circumstances in which the reliance of some members of the class was direct while the reliance of others was indirect. Other courts have refused class certification of state law claims on the belief that the fraud on the market theory is not available.

This Article has suggested that the fraud-on-the-market theory is most satisfactorily and appropriately viewed in the context of a substantive theory of class actions. In this context, the fraud-on-the-market theory provides a means of determining the issue of reliance on a class-wide basis. All efforts to defeat class certification by returning to individual issues of reliance, or by asserting conflicts between class members based on the manner of reliance, are thereby eviscerated. This general mode of determining reliance is fully justified on the basis of the remedial and structural policy goals underlying both a rule 10b-5 private right of action and a state law claim for fraud or negligent misrepresentation.