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Confounding Factors:
Misuse of the Fraud on the Market Theory

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INTRODUCTION

In most cases, stock trading prices are determined solely by the information surrounding the stock market. Therefore, inaccurate information disseminated within the market will affect stock prices -- driving them up or down artificially. Sometimes that information may be falsified for the purpose of fraudulent market manipulation. Because the amount of information on stocks is vast, and stocks trade hands at a rapid pace, the consumer may not always personally encounter the false information or the party who distributed it. Regardless, this misinformation alters the value of the stock, and this consumer should be able to sue for fraud because he or she is harmed just as much as the consumer who did encounter the misinformation personally.

What is described briefly above is referred to by economists as the fraud-on-the-market theory. This theory was first accepted as evidence of stock fraud by the United States Supreme Court in *Basic Inc. v. Levinson*. Although it was adopted specifically for cases dealing with the stock market, other courts have recently begun to use the theory in cases outside the stock market. Thus far, in cases outside the stock market, several courts have rejected the argument that false information reflected in the price of the product is sufficient to support a case for fraud. Nevertheless, courts have given serious consideration to use of the theory with goods that may be, arguably, analogous to stocks.

This article will examine the general legal standard used in fraud cases, explain how the fraud-on-the-market theory works within the legal standard, and analyze two cases where the fraud-on-the-market theory was raised outside the stock market context. Due to the complexity of the fraud-on-the-market theory, the case precedent has been erratic; judges ruling on future cases where

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this theory comes into play may not have a clear guideline for its use. Complications can occur when abstract economic theory is used in ruling on concrete legal issues. This article will incorporate considerations from previous cases to provide an argument as to when the theory is acceptable for outside the stock market. Such an analysis can help judges to be able to better control both when and how the fraud-on-the-market theory is used.

LEGAL STANDARD

General Legal Standard for Fraud

In order to understand how the fraud-on-the-market theory works, the general legal standard for common law fraud must first be outlined. In a basic fraud case, the plaintiff must prove five elements:

(a) a material misstatement of a fact must have been made,
(b) the fact was known to be a falsity by the giving party,
(c) the fact was given with the intent to deceive,
(d) the fact was relied upon[1] by the victimized party (plaintiff),
(e) the reliance on the fact caused some form of harm to the victim (plaintiff).[2]

The combined effect of categories (d) and (e), called "proximate causation," is where the fraud-on-the-market theory comes into play.

Basic Inc. & the Fraud-on-the-Market Theory

The fraud-on-the-market economic theory was originally accepted by the United States Supreme Court in *Basic Inc. v. Levinson.*[3] In prior fraud cases, *direct* reliance (part (d) of the legal standard) had been needed to establish a valid claim. In other words, courts required the victim to prove that he or she personally came across the false information or did business directly with the defrauding party.

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1 ' Relied upon' refers to the fact that the information affected the buying decision of the victimized party.
2 Oliveira v. Amoco Oil, 203 Ill. 2d 134, 149 (Ill. 2002).
3 Basic Inc. v. Levinson, 485 U.S. 224 (1988).

However, the Supreme Court realized that the stock market was somewhat unique when it stated in *Basic Inc.* that:

> The modern securities markets, literally involving millions of [shares of stock] changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of [the] reliance requirement must encompass these differences. In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor. With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. *The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price*.[4]

In the stock market arena, purposely-misleading statements about a company, its product, its management team, its competitors, et cetera, will deceive consumer-investors and affect their actions. The stock's price can rise or drop artificially because the price is based on the information present in the market. However, not all of the consumers will encounter the deceptive statements or do business directly with the defrauder; this is due to the rapid pace at which shares are exchanged and the arms length nature of the marketplace. Instead, consumers may buy or sell based upon the rise and fall of the market price, because they believe that the price is reflective of the stock's true value. Nevertheless, those consumers are harmed just as much as those who came across the inaccurate statements directly; the harm to all investors is that they are paying a higher or lower price than they should for their shares.

The purpose of the fraud-on-the-market theory is to eliminate the need for proof of *direct* reliance on this misinformation. The reasoning behind allowing *indirect* reliance to suffice is that the stock market has become too impersonal to realistically treat it otherwise. Requiring a consumer to have direct reliance would mean that only those who encountered the deceptive advertising or the defrauder face-to-face would have a legal claim. However,

[4] *Id* at 243-44 (emphasis added).

the intervention of one or more third parties in the polluted stock market scenario doesn't lessen the fact that the victim has been harmed by the false information that originally polluted the market. What happens to the consumer who encounters the misleading information through a third party? Should he or she still have a case?

The answer to this question is not always simple. To sue the intermediary for fraud, the intermediary must have been aware that the information was misleading and intended to continue the deception (because *knowledge* of the misleading information and *intent* to deceive are required under parts (b) and (c) of the legal standard for fraud). If third parties are not aware that the information they pass along on is incorrect, they would be exempted from liability for fraud.

Furthermore, even if the victim is aware of whom the defrauding party is yet received the misinformation through a third party, if the stock fraud standard required *direct* reliance, the victim could not sue the defrauder due to the lack of proximate causation. The victim is not in direct contact with the defrauder; therefore, part (d) of the legal standard -- reliance -- is missing, leaving the victimized party without a remedy.

Although the fraud-on-the-market theory allows for use of *indirect* reliance to cure this problem, the Supreme Court recognized that there are cases where its use may be inappropriate. In other words, as much as the use of the fraud-on-the-market theory may provide a presumption of reliance, that presumption of reliance on the misinformation is still rebuttable.[5] The Court elaborated when it said that:

> Any showing that severs the link between the alleged misrepresentations and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the [fraud-on-the-market] presumption of reliance.[6]

The Court meant that even if the first four elements of fraud were satisfied (misinformation, given with knowledge and intent, which is relied upon), it is still up to the plaintiff to prove that the misinformation actually caused the fluctuation in the price of the product. In other words, the plaintiff still needs to

[5] *See id.* at 250.
[6] *Id.* at 248.

prove that he or she relied upon the polluted market valuation of the stock, and that this *reliance* led to the *harm*.

This idea of the rebuttable presumption comes into play, and renders the fraud-on-the-market theory invalid, if the defendant can prove that there were intervening factors in the market's valuation of the stock price. For example, if there are misleading advertisements put out for a certain company but there also happens to be a coincidental depression in the stock market and all of the stocks in the market fall, the misleading information may not be reflected in the price. Assume the stock in question didn't drop in value any more than all other stocks traded in the market. In such a case, the false information does not cause any harm to the particular stock in question, but rather the market-wide depression would have been the cause of the price drop (and the fraud-on the-market theory is rendered invalid).[7]

Conversely, even in the above situation with the intervening market-wide depression, if the plaintiff could prove that the advertisements caused a significant drop in one company's stock compared to the other companies, a case for fraud might be established with the fraud-on-the-market theory. Thus, as explained by the Court in *Basic Inc*., the policy behind accepting rebuttable presumptions such as the fraud-on-the-market theory is to "assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult,"[8] and "[for the purpose] of fairness, public policy, and probability, as well as judicial economy, presumptions are also useful devices for allocating the burdens of proof between parties."[9] The question remains as to whether this same logic should be used outside the stock market context.

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[7] This scenario is similar to what happened in a case called *In Re Merrill Lynch* in which the plaintiffs alleged that the analysts at Merrill Lynch did not believe the reports they were putting out were true. Despite the use of the fraud-on-the-market theory to prove indirect investor reliance on the false reports, the Merrill Lynch Court found that there was an intervening factor of a market-wide depression. Therefore, even if the reports put out by the Merrill Lynch analysts were misleading, the reports did not cause the harm done to the plaintiffs and no case for fraud was found. *See. e.g.,* In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation, 272 F. Supp. 2d 243, 261-62 (S.D.N.Y. 2003).

[8] *Basic Inc.*, 485 U.S. at 245.

[9] *Id.*

Basic Inc. as Precedent

Despite the fact that the fraud-on-the-market theory helps solve the challenge of proving reliance, it is still a relatively new economic theory. In his *Basic Inc.* dissent, Justice White raised the following concern:

> [T]he fraud-on-the-market theory is a mere babe. Yet today, the Court embraces this theory with the sweeping confidence usually reserved for more mature legal doctrines. In so doing, I fear that the Court's decision may have many adverse, unintended effects as it is applied and interpreted in the years to come.[10]

Justice White's concern is not unreasonable in that:

> [As much as] the federal courts have proved adept at developing an evolving jurisprudence of [Rule 10b-5[11] the courts lack] staff economists, experts schooled in the "effective-capital-market hypothesis," [and the] ability to test the validity of empirical market studies.[12]

The result of this lack of resources is that "confusion and contradiction in court rulings [become] inevitable when traditional legal analysis is replaced with economic theorization."[13]

As of today, the fears put forth by Justice White in his dissent in *Basic Inc.* have come to pass. Recently, the Illinois courts have begun to consider the fraud-on-the-market theory in cases outside of the stock market; the result is confusion for other judges seeking precedent for future cases. This article will analyze two cases from the Illinois courts where the fraud-on-the-market theory was presented outside of the stock market.

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[10] *Id.* at 250-1 (White, J., dissenting).

[11] Rule 10b-5 is the federal Securities and Exchange Act's equivalent of the general legal standard of fraud.

[12] *Basic Inc.,* 485 U.S. at 253 (White, J., dissenting).

[13] *Id.* at 252.

CASE STUDY ONE: OLIVEIRA V. AMOCO OIL

Court's Ruling

Oliveira v. Amoco Oil[14] is a case from the Illinois Supreme Court where the fraud-on-the-market theory was used by a plaintiff (Oliveira) in a situation outside of the stock market. The plaintiff alleged that Amoco Oil distributed advertisements for its premium gasoline that were misrepresentative of its actual performance. The result of this ad campaign, according to Oliveira, was artificially inflated gas prices due to the increased consumer demand.

Oliveira claimed that the Amoco advertisements caused him harm when he bought the gas at the inflated price. However, Oliveira did *not* claim that *he* was "induced to buy the gasoline or that *he* was deceived by the ads. Nor did [Oliveira] claim that *he* saw, heard or read any of the allegedly deceptive advertisements."[15] Instead, Oliveira based his claim on the theory that others were deceived, and that they in turn acted as intermediaries in the fraudulent rise in the price Oliveira ultimately paid for gasoline.

Due to the legal posture of the appeal, the Illinois Supreme Court skipped over the first three prongs for fraud and concentrated on *reliance.* Displaying a great deal of general reluctance to use of the fraud-on-the-market theory, the Court ultimately rejected its use to prove Oliveira's *indirect* reliance on the ads because he was attempting to bring a class action suit. In other words, all members of the plaintiff class would need to be treated similarly when it came to the sufficiency of their evidence. The Court would be forced to consider hypothetical consumers who *had* read the ads directly, in addition to consumers such as Oliveira who had *not* read the ads. The Court was not willing to merge these two types of legal analysis (direct and indirect reliance) together into a single class action suit, which meant that since the fraud-on-the-market theory was inapplicable for some members of the plaintiff class, the Court would not consider use of the theory for Oliveira either.[16]

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[14] Oliveira v. Amoco Oil 201 Ill. 2d 134 (Ill. 2002).
[15] *Id.* at 140 (emphasis added).
[16] *Id.* at 154-55.

Analysis of the Oliveira Ruling

The significance of this case is that it serves as an example of the inevitable confusing and contradictory court rulings that Justice White feared would come to pass when he wrote in his *Basic Inc.* dissent. When looking at appropriateness of the fraud-on-the-market theory in the context of *Oliveira,* there are several factors the Oliveira Court failed to consider before rejecting use of the theory on procedural grounds.

First, the fraud-on-the-market theory is not necessarily inappropriate in the context of *Oliveira* because oil is sold at a uniform rate per barrel. This is very similar to the valuation of shares of stock in a particular company; each share is traded at a uniform price at any given moment it time. Absent market manipulation or other extraordinary circumstances, neither oil nor stocks depreciate rapidly over time. Market manipulation, to the extent it does cause an unusual shift in the price, must be specifically proven.

With regard to the appropriateness of the fraud-on-the-market theory, even if the theory is allowed, the burden of proof still rests on the plaintiff to prove the *harm* because the theory only satisfies *reliance*. The existence of other factors that may have caused the harm instead must be ruled out. Transportation cost, refinery costs, location, et cetera, can all affect the price of gas differently, to the extent that the same gasoline is selling at different prices in different locations. If misleading ads are also affecting the price of a certain company's gasoline *vis a vis* its competitors, those ads should (theoretically) have a uniform effect on the price of all of the company's gas. Because the plaintiff must show that actual harm was caused by the misleading ads in particular, it would be the plaintiff's burden to determine how much each possible causal factor goes into the valuation of the local gasoline he or she purchased.

The following chart provides a visual demonstration reflecting the impact of differing costs on local pricing in a hypothetical scenario:

Hypothetical Oil Costs	Location of Station:	Location 1	Location 2	Location 3
Distance from Refinery in miles		20	10	5
Original Cost/Barrel	$25.00	$25.00	$25.00	$25.00
Refinery Cost	$30.00	$30.00	$30.00	$30.00
Transportation Cost per mile	$1.00	$20.00	$10.00	$5.00
Effect of Misleading Ads	**$4.00**	**$4.00**	**$4.00**	**$4.00**
	Total Cost:	$79.00	$69.00	$64.00

In this hypothetical scenario, all of the total costs are different by region, but the misleading ads have a uniform effect of raising the price by four dollars. Regardless of whether or not certain consumers read the ads, some consumers will read and believe the ads and be willing to purchase at a higher price, thereby distorting the value of the gas for everyone. All consumers -- those who read the ads *and* those who did not -- will find later that their product is defective (i.e., does not live up to the artificially inflated value). By then, the damage will already have been done to everyone who is purchasing at that unrepresentative price.

To require *direct* reliance in the case of gasoline is unreasonable because not all consumers will encounter the ads. The fraud-on-the-market theory can be used to protect even those consumers who were affected *indirectly* by the fraudulent ads (satisfying prong (d) of the legal standard). However, it is very important to keep in mind that when it comes to proving *harm* (prong (e) of the legal standard), our hypothetical plaintiff should only be allowed to collect his or her share of four dollars per barrel in damage for the duration of the ad campaign. The court should insist that the plaintiff is ready to prove this financial harm with specificity, so that other cost factors do not blur the analysis.

Thus the fraud-on-the-market theory is not *necessarily* inappropriate for cases outside of the stock market. However, because information in the form of advertisements is not the *sole factor* used to determine the price of a commodity like gasoline by the time it reaches the consumer, great care must be taken to carved out the true impact of any fraud on the marketplace as a whole. What can be gleaned from this, in terms of a guideline, follows the hypothetical customers who read the misleading ads and who do *not* believe the ads but buy the product anyway. In such a case, reliance may not seem to be present at first blush, but could be proven in certain cases with the fraud-on-the-market theory. This should be carefully distinguished from cases where the plaintiff knows that the ad is false and therefore declines to purchase (thus, arguably, no clear financial *harm*).[17]

[17] An example of a case where the plaintiff does not believe the price is reflective of the true value is Hemispherx Biopharma, Inc v. Asensio, 199 U.S. Dist. Lexis 2849 1 (E.D. Pa. 1999). Here, Hemispherx Biopharma, Inc. (HBI) manufactured a drug called Ampligen. *Id.* at 5. The defendants, Asensio and others, produced misinformation regarding HBI in an attempt to artificially reduce the price of its stock for purposes of a short-selling scheme. *Id.* The trial court found that the information distributed by Asensio was indeed misleading and had been shared intentionally so that other people

The preceding analysis should also be carefully distinguished from cases where the plaintiff knows the ad is false and has a clear *substitute* yet specifically chooses to purchase the unrealistically expensive product anyway. If a "savvy buyer" was aware that a particular brand of premium gasoline, for instance, is artificially expensive, she could simply choose to purchase another brand instead. Thus, this savvy consumer can reasonably avoid any sort of financial harm, or if she consciously chooses to accept the higher price for her own reasons, she should be held accountable for making that choice.

CASE STUDY TWO: SHANNON V. BOISE CASCADE CORPORATION

Court's Ruling

Shannon v. Boise Cascade Corporation,[18] is another case where the fraud-on-the-market theory was raised outside of the stock market context. However, similar to the *Oliveira* case, the theory was misunderstood, resulting in another confusing ruling. In this case, Boise Cascade was a manufacturer of wood siding used on the exterior walls of houses; wood siding acts as a barrier between the outside air and the frame of the house. Boise Cascade had discontinued its wood siding production in 1984, but prior to that the company had been manufacturing wood siding since 1960. The wood siding came in

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would rely upon it, thus satisfying the first three elements of fraud. However, the trial court also found that HBI's actions did not demonstrate that *the company* relied upon the misinformation because the *company* was *not* buying shares of its own stock on the secondary trading market at the time the value of those shares might have been distorted. The trial court explained: "[T]he fraud-on-the-market theory does not eliminate the need for a plaintiff to have acted in reliance. It only eliminates the need for a plaintiff to have acted in *direct* reliance." *Id.* (emphasis added). Thus, even though harm to HBI's stock value may have occurred, that harm would only be felt by investors trading in HBI's stock (i.e., different potential plaintiffs). To the extent that HBI's reputation may have been hurt, the company would need to sue under some other legal standard -- perhaps defamation -- rather than stock fraud.

[18] Shannon v. Boise Cascade Corporation, 336 Ill. App. 3d 533 (2003). Editor's Note: This opinion by the Illinois Appellate Court was eventually reversed by the Illinois Supreme Court after the writing of this article. See the editorial notes following this article for more details.

differing grades (Grade A and Grade D[19]), but of the two, Boise Cascade only advertised its Grade A wood siding.[20]

The plaintiffs, the Shannon couple and several other consumers, all bought houses that were built in either 1983 or 1984. Two of the plaintiffs, Bruce Fischer and James Torongo, bought their houses brand-new in 1984 and were still residing in those homes. As for the other five plaintiffs, one bought his house in 1991 while the others bought their houses in 1997 from the original owners. The plaintiffs claimed that Boise Cascade's siding was "subject to rotting, buckling, warping, wick moisture, and general failure"[21] and that Boise Cascade "deceptively advertised the composite siding, falsely representing that the siding was of 'inherent good quality,' 'durable,' 'low maintenance,' and 'looked and performed comparably to natural wood siding.'"[22] Furthermore, the plaintiffs claimed that Boise Cascade purposely omitted the fact that its siding would not perform as expected and that it would require "highly particularized maintenance" among other things.[23]

When the trial court first examined the case, the court found that none of the relevant plaintiffs had personally encountered Boise Cascade's advertisements in any form. The trial court also found that the builder-seller of the plaintiffs' houses was not an agent of Boise Cascade. Thus, none of the plaintiffs had a case for *direct* reliance on the Boise Cascade ads. Finally, even though the trial court rejected the argument that advertisements disseminated by Boise Cascade were merely "puffing,"[24] the court stated that further inquiry would have to be made before any determination could be made as to whether or not the advertisements were actually *misleading*.[25] Because the trial court

[19] The Shannon Court did not explain what the difference between the grades of siding are, but the information found online specifies that the grade would determine the quality and durability of the siding.
See http://www.cedar-siding.com/cedar_products/siding-types/bevel/grades.htm (visited October 2005).
[20] *Shannon*, 336 Ill. App. 3d at 545.
[21] *Id*. at 538.
[22] *Id.*
[23] *See id.*
[24] 'Puffing' refers to a statement in an advertisement which is so subjective that no reasonable consumer would rely upon it. For example: "This product is the best money can buy."
[25] *Shannon*, 336 Ill. App. 3d at 538-39.

saw no way that the plaintiffs could satisfy the *direct* reliance standard on the facts alleged, the court granted summary judgment to Boise Cascade.

The plaintiffs appealed to the Illinois Appellate Court, insisting that they had alleged sufficient facts which, if ultimately proven to be true, could satisfy all of the elements for a fraud claim.[26] Since the first three aspects of fraud are the material misstatement of a fact, knowingly transmitting the misrepresented fact, and having the intent to deceive consumers with the misrepresentation, the Appellate Court looked to see what the trial court had found with regard to these elements. The Appellate Court also looked at evidence as to the plaintiffs' exposure to the misrepresentations at issue:

> [W]hile further discovery may be necessary to determine whether Boise Cascade's marketing activity was false, misleading, or otherwise deceptive, [we can determine from the record that these] plaintiffs 'neither saw, heard, or otherwise were aware of the defendant's advertising,' which [is] strictly a legal issue.[27]

Therefore the Appellate Court explained:

> For the purposes of this appeal, we assume [for the time being], as did the circuit court, that Boise Cascade's composite siding was defective, that Boise Cascade's representations were deceptive, and that Boise cascade concealed facts with the intent that others rely thereon.[28]

Thus the Appellate Court shifted its focus to the remaining elements of fraud (*reliance* and *harm*).

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[26] The *Shannon* case actually dealt with an Illinois statutory claim; however, for purposes of this article, the elements of that claim are functionally equivalent to the elements for a basic case of common law fraud.
[27] *See id.*
[28] *See id.* at 539.

To satisfy the reliance element, the Appellate Court appeared to accept fraud-on-the-market argument.[29] In doing so, the Appellate Court disagreed with the trial court over whether or not privity[30] was a requirement for reliance and whether or not Boise Cascade should have foreseen[31] that there would be subsequent buyers. The trial court had ruled against the plaintiffs, indicating that the plaintiffs needed to have done business *directly* with Boise Cascade, or at least to have had *direct* exposure to the ads, for reliance to be present. Thus, the trial court had concluded that without having read the ads, the harm could not have been properly caused to these plaintiffs by any misrepresented facts within Boise Cascade's ads.[32]

The Appellate Court, on the other hand, took the opposite view and appeared to accept the fraud-on-the-market theory as a form of *indirect* reliance. Therefore, it could be reasoned that even though none of the plaintiffs had read any of the ads, Boise Cascade should have still foreseen that subsequent buyers in their position could have been harmed.[33] By omitting the fact that their wood siding was defective to the original owners, Boise Cascade brought about the possibility that the prices of the houses would not reflect the defect when resold to other consumers such as the plaintiffs. The plaintiffs, assuming the market price reflected the home's true value, were then damaged

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[29] Editor's note: the Court referred to the plaintiffs' "marketing theory" of proximate causation (reliance plus resulting harm). At times, it appears that this was taken to mean the same thing as the fraud-on-the market theory. At other times, however, it appears that some judges (the dissenter in particular) might have taken this to mean that even if *no one* saw the ads in question (thus neither direct nor indirect reliance ocurred), the ads somehow created a "market" for Boise Cascade siding in the plaintiffs' neighborhood. *See id.* at 632-33. As the dissent helps to illustrate, such a use of the term "marketing theory" would lead to a different result than the Supreme Court intended in *Basic Inc.*, where the fraud-on-the-market theory was used merely to allow for evidence of indirect reliance in addition to direct reliance.

[30] 'Privity' merely refers to the fact that the two parties were directly doing business with each other.

[31] 'Forseeability' is a concept which the courts use to determine whether or not a defendant should have reasonably anticipated the consequence of its actions.

[32] In his dissent, Judge Turner suggests that the trial court found no evidence that *anyone* had ever read Boise Cascade's siding ads and that several plaintiffs were actually aware of siding defects at the time they purchased their homes. *Shannon*, 336 Ill. App. 3d at 633 (Turner, J., dissenting).

[33] *Id.* at 544.

when they bought the houses because they paid more than they should have. Therefore, *reliance* and *harm* were satisfied, and the Appellate Court remanded the case to the trial court for further consideration of the other elements that had yet to be proven.[34]

Analysis of the Shannon Ruling

In relation to the houses in *Shannon*, the Illinois Appeals Court erred by essentially collapsing *reliance* and *harm* into one category, because the fraud-on-the-market theory is only intended to satisfy *reliance*, the fourth prong of the legal standard for fraud. In the case of the houses, the original owner of a new house has a reasonable expectation that any siding warranties presented, either directly or indirectly, can be relied upon.[35] The next buyer should also be able to expect that the house retains the same value relative to when it was first bought, particularly if the claim made by the company is that the siding would last for longer than what the warranty covered. This is very similar to stock because when stock is purchased and resold to the next investor, that investor has a reasonable expectation that (absent some other intervening factor) the stock will retain its market-driven value. Therefore, the *Shannon* court is correct in stating that Boise Cascade should have foreseen that there could be subsequent buyers affected by any misstatements of fact in its ads.[36]

When considering the causation of the *harm*, however, the *Shannon* court erroneously allowed the fraud-on-the-market theory to be used once again. This can be problematic because when recovering damages, the plaintiffs may recover more than they are entitled to, which does not allow for other causes to be properly considered. For example, if the original owner was negligent in caring for the house, then there is certainly an intervening, or at least additional, cause not considered by the *Shannon* court. This would be analogous to the earlier stock market example where the bursting of the stock market bubble caused the depreciation in the value of *all* stocks on the market; the sudden depression was the intervening cause of value lost by any particular stock.

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[34] *Id.* at 541-44.

[35] A separate aspect of the legal standard for *reliance* deals with several specific considerations that might make reliance upon such warranties "unreasonable." That issue is beyond the scope of this article.

[36] *Id.* at 544.

The way the *Shannon* court used the fraud-on-the-market theory also does not account for the possibility that subsequent owners such as the plaintiffs may have failed to appraise the house correctly prior to buying it. The fraud-on-the-market theory operates to protect a buyer who has no knowledge of a hidden defect and believes that the prevailing market price is reflective of the home's true value. By actually appraising a house, the potential buyer's actions will then reflect a different -- fully informed -- mix of information about the home's true worth. The "informed buyer" could simply forego the purchase, find another house properly valued, and reasonably avoid any harm.

If the informed buyer does choose to pay more than the home is worth, that buyer should bear responsibility for his or her actions. A buyer who actually discovers a defect, but *chooses* to buy the house anyway at the inflated price, would be analogous to the hypothetical consumer who disbelieves deceptive ads but *chooses* to buy premium gasoline at the artificially inflated price despite the existence of possible alternatives. Neither buyer should be able to deflect the court's attention from this intervening cause of any financial harm.

To avoid this problem, courts should carefully examine the facts alleged to prove *both* indirect reliance (through the fraud-on-the-market theory) *and* actual causation of harm (beyond any reference to fraud-on-the-market). Proof of harm should take into account not only the broad mix of factors that affect a product's price (as discussed in the gasoline illustration), but also any evidence that the consumer had sufficient actual information to know that the prevailing market price had been artificially distorted. A consumer who ignores this actual information of market price distortion should not be able to raise a fraud-on-the-market argument for the *harm* element of a fraud claim unless the court finds that the consumer had no choice but to purchase the product at the distorted price.

CONCLUSION

The United States Supreme Court had originally accepted the fraud-on-the-market theory in *Basic Inc.* to keep the general legal standard of fraud intact, particularly "proximate cause." However, by using the fraud-on-the-market theory in a manner that combines *reliance* on the market price and *harm* into one category, the Appellate Court of Illinois in *Shannon* would essentially be allowing consumers to avoid having to prove causation, which still ought to be required in any fraud case. When new abstract theories such as fraud-on-the-market are adopted for use as case precedent, clear guidelines should also be given as to how these theories should be applied and limited. By considering these guidelines, abstract concepts will be less likely to confound those judges who do not necessarily have time or resources to gain a thorough understanding of the underlying theoretically principles. Given the complexity of abstract concepts such as the economic theory underlying the fraud-on-the-market approach, one cannot expect every judge to appreciate the theory in the same manner a trained theorist would. Careful guidance in presenting abstract concepts to future courts -- this theory in particular -- should result in fewer confused or contradictory rulings in the future.

EDITORS' NOTE:

The Shannon case discussed in this article actually had a very interesting journey through the courts. The Illinois Appellate decision referenced here was ultimately vacated by the Illinois Supreme Court, which had directed the Court of Appeal to reconsider its decision in light of the Illinois Supreme Court's decision in the Oliveira (gasoline) case.[37] *The Appellate Court virtually reissued its original opinion,*[38] *and a "vexed" Judge Turner included the same dissenting concerns.*[39] *The Illinois Supreme Court then reversed the Appellate Court and reinstated the trial court's initial ruling granting summary judgment to Boise Cascade, the siding company.*[40] *Of particular concern throughout the process were the lack of factual findings that anyone had ever seen the Boise Cascade ads and the finding that at least some of the plaintiffs had been aware of the siding defects (by way of independent appraisals) when they chose to purchase their homes. Thus, these judges shared the latter concern with our author, Mr. Tan.*

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[37] Shannon v. Boise Cascade, 201 Ill. 2d 615 (Ill. 2002).
[38] Shannon v. Boise Cascade, 336 Ill. App.3d 533 (Ill. Ct. Appl. 2003).
[39] *See id.* at 546-547.
[40] *See* Shannon v. Boise Cascade, 208 Ill. 2d 517 (Ill. 2004).

Although the three justices of the Illinois Supreme Court panel ruled in favor of the siding company, the opinion (delivered by Justice Kilbride) suggests that the fraud-on-the-market theory might have been appropriate if the plaintiffs could have proven that someone actually did see the ads, that the ads had some impact on the valuation of the homes, and that the plaintiffs, in turn, were thus indirectly affected by those ads.[41] *Justice Thomas took exception to this "dicta," arguing that it runs contrary to the prior precedent set by a divided panel of different justices from the Illinois Supreme Court in the Oliveira case. In a special concurrence joined by Justice Garman, Justice Thomas expressed his own "vexation" with the dicta and the ongoing confusion over the relevant issues.*[42]

The entire Illinois litigation process emphasizes the potential for the very confusion and contradiction over use of the fraud-on-the-market theory that our author has warned about. While the various judges demonstrated differing levels of appreciation for the twists and turns of this abstract theory, the parties to the case were tied up in litigation for many years and precedent in Illinois still remains unclear.

Meanwhile, the United States Supreme Court had the opportunity to address the general contours of the fraud-on-the-market theory once again in a recent stock fraud case.[43] *Delivering the opinion for a unanimous Court, Justice Breyer explained that using a tool such as the fraud-on-the-market theory to prove 'reliance' in a fraud case does not necessarily demonstrate the plaintiff has also shown any sort of legally cognizable 'harm.' In reversing the approach taken by the Ninth Circuit Court of Appeals, the Supreme Court pointed out that a plaintiff cannot show actual 'harm' in a fraud case simply because she has been tricked into purchasing stock at an artificially inflated price. Rather, she must be able to show that she has lost money when actually attempting to resell the stock after the artificial effect of the fraud has ended.*

Accusing the Ninth Circuit of misunderstanding precedent, the objective of stock fraud law, and "pure logic" throughout the opinion, Justice Breyer explained:

> *[A]t the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share [of stock] that 'at that instant' possesses*

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[41] *See id.* at 528.
[42] *See id.* at 530-32.
[43] Dura Pharmaceuticals, Inc. v. Broudo et al., No. 03-932 (2005).

> *equivalent value. Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong. … Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will 'sometimes' play a role in bringing about a future loss.*[44]

Interestingly, the opinion also includes a quote from Justice White's dissenting opinion in Basic Inc. v. Levinson:

> *[Federal law makes stock fraud actionable], not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.*[45]

Thus, if the plaintiff sells before the fraud is discovered, or if she decides not to sell, or if she loses money selling a stock that has lost value for other reasons, her fraud claim fails. In such a case the issue is no longer about the distinction between direct or indirect reliance (where the fraud-on-the-market theory comes to bear), but rather whether the plaintiff has properly shown that the fraud caused her actual (rather than potential) harm. In this ruling, the Supreme Court has recognized the very same concern (collapsing 'reliance' and 'harm' analysis) raised by our author, Mr. Tan.

Unfortunately, as Mr. Tan has explained, it is unlikely that every jurist in America will be ready to undertake this sophisticated analysis of the underlying economic theory behind the fraud-on-the-market presumption. Continuing guidance from the U.S. Supreme Court will be extremely valuable. However, the Court has yet to give clear guidance as to what cases, other than stock market cases, could be appropriate vehicles for use of the presumption.

[44] *Id.* at (II)(A)(¶ 2-3) (emphasis in original).

[45] *Id.* at (II)(A)(¶ 7) (quoting Basic Inc., 485 U.S. at 252 (White, J., joined by O'Connor, J., concurring in part and dissenting in part)).