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Securities Law - The Artificially Inflated Purchase Price Theory: An Economically Sound Yet Legally Insufficient Method of Pleading and Proving Loss Causation, *Dura Pharmaceuticals v. Broudo*

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SECURITIES LAW—The Artificially Inflated Purchase Price Theory: An Economically Sound yet Legally Insufficient Method of Pleading and Proving Loss Causation, *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627 (2005).

INTRODUCTION

The United States Supreme Court decided the case of *Dura Pharmaceuticals v. Broudo* in 2005, and has been heralded as the “most important securities case in a decade.”¹ In *Dura*, Respondents (Investors), members of a securities class action lawsuit, invested in shares of Dura Pharmaceuticals (Dura) during a ten-month interval between April 1997 and February 1998.² They alleged that before and during the purchase period, Dura officials made false and misleading statements concerning the pending FDA approval of their new asthmatic spray device, as well as the profitability of the company.³ With respect to the profitability, the Investors alleged that Dura falsely claimed that it expected its drug sales to prove profitable.⁴ With respect to the asthmatic inhaler, the Investors alleged that Dura falsely claimed the FDA would grant approval for the device.⁵ On the last day of the purchase period, Dura announced that lower drug sales had led to a significant decrease in earnings.⁶ Subsequently, shares of Dura dropped from thirty-nine dollars to twenty-one dollars.⁷ In November, Dura further announced that the FDA had not approved its spray device for consumer con-

1. Patti Waldmeir, *Supreme Court to Rule on ‘Most Important Securities Case in a Decade,’* FINANCIAL TIMES, Jan. 10, 2005, at 5.

2. *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627, 1630 (2005). The class period for this action is between April 15, 1997 and Feb. 24, 1998. Respondents’ Brief at 3, *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627 (2005) (No. 03-932) [hereinafter Respondents’ Brief].

3. See *Dura Pharmaceuticals*, 125 S. Ct. at 1630. Dura was awaiting FDA approval for its AIs Spiros asthmatic inhaler, a device that was to act as a growth catalyst for Dura with an anticipated increase of \$58 million in earnings in 1999 and \$100 million in 2000. Respondents’ Brief at 3. Investors argue that Dura’s misleading profitability projections were also linked to Ceclor CD sales. *Id.* at 1. Ceclor CD is an antibiotic medicine. *Id.* Investors contend that Dura made false statements that sales of the drug were increasing when in fact sales of Ceclor CD dropped by nearly fifty percent from March to July of 1997. *Id.*

4. *Dura*, 125 S. Ct. at 1630.

5. *Id.*

6. *Id.*

7. *Id.* Additionally, Dura announced that it would increase its sales force by sixty-six percent to increase sales of Ceclor CD and to remove unneeded inventory. Respondents’ Brief at 4. The price of Dura’s stock dropped from a high of \$39-1/8 on February 24, 1998 to \$20-3/4 on February 25, 1998. *Id.* at 5. Trading for the stock reached a staggering thirty-two million shares. *Id.*

sumption.⁸ The next day, Dura shares lost a significant percentage of their value, but recovered to previous marks in less than one week.⁹ Respondents alleged that Dura's misrepresentations artificially inflated the stock's price on the day of purchase and therefore caused a significant economic loss for Dura shareholders.¹⁰

Plaintiffs brought suit in federal court in California.¹¹ Their complaint alleged that "in reliance on the integrity of the market, [the plaintiffs] . . . paid artificially inflated prices for Dura securities" and the plaintiffs suffered damages thereby.¹² The district court dismissed the complaint.¹³ Regarding the plaintiffs' profitability claim, the court held the plaintiffs had failed to adequately allege the defendants had the requisite state of mind.¹⁴ Regarding the asthmatic inhaler claim, the court held the plaintiffs had failed to adequately allege loss causation.¹⁵

The Investors appealed the decision of the district court to the United States Court of Appeals for the Ninth Circuit.¹⁶ The Ninth Circuit reversed the lower court's ruling.¹⁷ The court held the Investors' asthmatic spray device claim had adequately alleged loss causation.¹⁸ The court said, "plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation."¹⁹ The court also added, "the injury occurs at the time of the transaction" because at "the time of purchase [the securities' price] was overstated."²⁰ Because the posi-

8. *Dura*, 125 S. Ct. at 1630. In November of 1998, the FDA rejected Dura's AlSpiros ashmatic inhaler saying that it was neither reliable nor stable. Respondents' Brief at 5. The FDA required Dura to conduct a new clinical study. *Id.*

9. *Dura*, 125 S. Ct. at 1630.

10. *Id.* at 1631. Plaintiffs claim that class period highs were over \$50 per share, while the mean trading price for the ninety day look-back period was \$12.96. Respondents' Brief at 5.

11. *Dura*, 125 S. Ct. at 1630.

12. *Id.* (internal quotations omitted).

13. *Id.* The district court dismissed the complaint because it held that the plaintiff had not pled loss causation as to the false AlSpiros statements. Respondents' Brief at 6.

14. *Dura*, 125 S. Ct. at 1630.

15. *Id.*

16. *Id.*

17. *Id.* The appellate court found that the district court had erred in considering the allegations separately rather than as a whole. Respondents' Brief at 7.

18. *Dura*, 125 S. Ct. at 1630.

19. *Id.* (quoting *Dura Pharmaceutical v. Broudo*, 339 F.3d 933, 938 (9th Cir. 2003)).

20. *Id.* (quoting *Dura Pharmaceutical v. Broudo*, 339 F.3d 933, 938 (9th Cir. 2003)).

tion of the Ninth Circuit differed from the positions taken by other circuits, the United States Supreme Court granted *Dura*'s petition for certiorari.²¹

The issue before the Supreme Court was whether an inflated share price, by itself, will proximately cause the economic loss needed to allege and prove "loss causation."²² *Dura* argued "[t]here can be no question that in order for the loss causation requirement to have any meaningful application at the pleading stage, a plaintiff invoking the fraud-on-the-market theory must establish a causal connection between the defendant's alleged fraud and the post-transaction decline in stock price for which the plaintiff seeks to recover losses."²³ Contrarily, the Investors claimed, "under Ninth Circuit law, 'for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock actually occurred, because the injury occurs at the time of the transaction.'"²⁴ Essentially, the Investors claimed "loss most proximately and directly caused by fraud is the difference between price and value on the date of purchase—not some later decline in price."²⁵

The Supreme Court reversed the decision of the United States Court of Appeals for the Ninth Circuit holding that an inflated share price alone does not cause the relevant economic loss needed for a fraud-on-the-market cause of action.²⁶ Subsequently, the Court held the Investors' allegations were insufficient to state a valid claim of fraud.²⁷

21. *Id.*

22. *Id.* The opposing parties stated the issue differently. *Dura* stated the issue as, "[w]hether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price." Petitioners' Brief at 1, *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627 (2005) (No. 03-932) [hereinafter Petitioners' Brief]. Investors stated the issue was "[w]hether to plead loss causation in a Section 10(b) open-market fraud case plaintiffs must do more than plead facts establishing fraud-based inflation and overpayment on the date of their purchase." Respondents' Brief at 1.

23. Petitioners' Brief at 11.

24. Respondents' Brief at 7 (quoting *Knapp v. Ernst & Whitney*, 90 F. 3d 1431, 1438 (9th Cir. 1996)).

25. Respondents' Brief at 7-8.

26. *Dura*, 125 S. Ct. at 1633. The Ninth Circuit held loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. *Dura Pharmaceuticals v. Broudo*, 339 F.3d 933, 938 (9th Cir. 2003). The court merely required pleading that the price at the time of purchase was overstated and sufficient identification of the cause. *Id.*

27. *Dura*, 125 S. Ct. at 1633. The federal rules require a short and plain statement of the claim showing that the pleader is entitled to relief. FED. R. CIV. P. 8(A)(2). This statement must provide the defendant with fair notice of what the

Dura Pharmaceuticals v. Broudo is the seminal decision regarding the artificially inflated purchase price theory and loss causation. Initially, this case note will discuss the development of the loss causation principle. The background section will explore how loss causation and private securities fraud causes of action are viewed under the law, specifically focusing on the Securities Exchange Act of 1934, the SEC Rule 10b-5, the common law development of the loss causation principle, the congressional codification of loss causation, and the indecision among the circuit courts over the artificially inflated purchase price theory. This case note will then discuss the United States Supreme Court's decision in *Dura Pharmaceuticals v. Broudo*, where the Court determined an artificially inflated purchase price is not sufficient to plead and prove loss causation. This case note will argue that the Supreme Court's decision was incorrect as it was inconsistent with precedent, legislative history of the Private Securities Litigation Reform Act, and sound financial and public policy. Consequently, the Court's decision will severely hinder future investors with meritorious 10b-5 claims in proving loss causation.

BACKGROUND

Renowned Judge Posner stated that "what securities lawyers call 'loss causation' is the standard common law fraud rule . . . merely borrowed for use in federal securities fraud cases."²⁸ The often-misinterpreted theory of loss causation, which can be proven when a misrepresentation or omission causes an economic loss, developed out of both statutory mandate and common law.²⁹ This section will examine the historical roots and progression of this important doctrine in order to properly ascertain the current state of the law.

The Beginning of a Private Securities Fraud Cause of Action

While the primary focus of this case note is the concept of loss causation, it is important to address the origins of combating securities fraud before the concept of loss causation can be fully understood. Congress enacted The Securities Act of 1933 and the Securities Exchange Act of 1934 after the Great Depression primarily to promote investor confidence in the United States' securities markets and thereby encourage investment for capital formation, economic growth, and job creation.³⁰ Congressional findings pertaining to the stock market crash of 1929 revealed that "a variety of ma-

plaintiff's claim is and the grounds upon which it rests. *Conley v. Gibson*, 355 U.S. 41, 47 (1957).

28. *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 683 (7th Cir. 1990) (remarking that loss causation is the same as the common law fraud rule).

29. 37 AM. JUR. 2D. *Fraud and Deceit* § 275 (2005).

30. S. REP. NO. 104-98, at 683 (1995).

nipulative and deceptive trading practices existed in the securities market prior to the crash . . . thus reform was necessary to prevent future market disasters.³¹ The Securities Act of 1933 and the Securities Exchange Act of 1934 confronted these concerns.³² The 1933 Act addressed the distribution of securities while the 1934 Act contained provisions that increased investor protection in the secondary market.³³ Section 10b of the Securities Exchange Act of 1934 states in relevant part, “[i]t shall be unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate”³⁴ The purpose of this section is the protection of investors from a company’s manipulation and deceit, and it shows congressional intolerance of manipulative and deceptive devices in the securities market.³⁵

Under the power granted by Section 10b, the SEC promulgated Rule 10b-5 to combat securities fraud violations.³⁶ Rule 10b-5, entitled “Employment of manipulative and deceptive devices,” was designed to eliminate fraudulent schemes, material misstatements, material omissions, and fraudulent actions.³⁷ Rule 10b-5 has been coined “a powerful antifraud weapon,”

31. David S. Escoffery, Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995* (“PSLRA”), 68 *FORDHAM L. REV.* 1781, 1783-84 (2000).

32. *Id.* at 1784; Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (1995).

33. Escoffery, *supra* note 31, at 1783-84.

34. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (1995) (emphasis added). The “Commission” the Act refers to is the Securities and Exchange Commission (SEC), an enforcement agency that was established as a result of the 1934 Act. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 7-8 (2d ed. 1990). See Escoffery, *supra* note 31, at 1784 (stating that Congress gave the SEC the authority under the Securities Exchange Act of 1934 to enforce securities fraud statutes).

35. See Escoffery, *supra* note 31, at 1784.

36. Escoffery, *supra* note 31, at 1784. See also JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 681 (2d ed. 1997) (calling rule 10b-5 a powerful anti-fraud device).

37. 17 C.F.R. § 240.10b-5 (1998). SEC 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

and it is the primary resource both the SEC and private investors use to promote integrity within the securities marketplace.³⁸ While Rule 10b-5 does not expressly give investors the right to a private securities fraud remedy, or outline the elements of the offense, the federal courts have found Rule 10b-5 creates an implied right, and the rule has been instrumental in shaping the elements of a private securities fraud cause of action.³⁹ In addition to outlining a cause of action, the 1934 Act states in Section 9e that organizations shall be held liable for selling a security "at a price which was affected by [a misrepresentation or omission]."⁴⁰ This provision specifically states that damage occurs when the purchase price is affected by the misrepresentation.⁴¹ The language of section 9e can be used to help clarify the intent and purpose behind the language Congress used in Section 10b.⁴²

The courts have held that the Securities Exchange Act of 1934 and SEC Rule 10b-5 create an implied right for investors to seek damages from an organization that employs fraud or deceit while selling securities.⁴³ The damage an investor incurs in a 10b-5 action is created by a misrepresentation that affects the purchase price.⁴⁴ While loss causation was not specifically addressed in either of these provisions, Congress' use of the words "misrepresentation," "affects," and "purchase price," laid the groundwork for the formulation of the loss causation principle.

The Development of Loss Causation

Loss causation was not an element of a securities fraud cause of action under either the Securities Exchange Act of 1934 or under SEC Rule 10b-5.⁴⁵ Loss causation is a judicially created element of a securities fraud action, and because it has historical roots in the common law, it is important

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.

38. Escoffery, *supra* note 31, at 1785.

39. *Kardon v. National Gypsum Co.*, 69 F.Supp. 512, 513-14 (E.D. Pa. 1946).

40. Securities Exchange Act of 1934 § 9(e), 15 U.S.C. § 78i(1995).

41. *Id.* (emphasis added).

42. *Id.*

43. *Kardon*, 69 F.Supp. at 513-14.

44. *Id.*

45. See The Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (1934); see also 17 C.F.R. § 240.10b-5 (1998) (observing that loss causation is not an element of the offense under this section).

to examine the evolution of the concept through the course of judicial decision-making.

In 1974, the Second Circuit became the first court to formally recognize the term “loss causation” in *Schlick v. Penn Dixie*.⁴⁶ The court stated, “This is not a case where the 10b-5 claim is based solely upon material omissions or misstatements in the proxy material. Were it so, concededly there would have to be a showing of . . . loss causation—that the misrepresentations or omissions caused the economic harm”⁴⁷ In its decision the Second Circuit penned the term “loss causation” and stated that it easily could be proven when a misrepresentation causes economic harm.⁴⁸ The courts have struggled to apply this principle and in 1981 the Fifth Circuit tried to clarify the meaning of loss causation by stating that “[t]he plaintiff must prove. . . [that] the untruth was in some reasonably direct, or proximate, way responsible for the loss.”⁴⁹ Thus loss causation could be properly met by showing that the misrepresentation was the reason for the economic loss.⁵⁰ The concept of loss causation was originally developed in the context of primary market transactions where the shares are offered through an initial public offering.⁵¹ Until *Schlick*, the principle of loss causation had not been applied in a secondary market case, where shares are traded on an exchange.⁵² When a fraud occurs in a secondary market transaction, it is commonly referred to as “fraud-on-the-market.”⁵³ In a fraud-on-the-market cause of action, loss causation and the other essential elements of 10b-5 must be adequately pled and proven for an investor to be successful in such a case.⁵⁴

The United States Supreme Court decided the seminal case regarding fraud-on-the-market claims in *Basic Incorporated v. Levinson*.⁵⁵ The *Basic* Court faced a situation where the investors and subsequent sellers of stock filed a 10b-5 action alleging Basic made material misrepresentations when the company denied the existence of merger negotiations prior to the

46. *Schlick v. Penn Dixie*, 507 F.2d 374 (2d Cir. 1974).

47. *Id.* at 380.

48. *Id.*

49. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981).

50. *Id.*

51. See Merritt B. Fox, *Understanding Dura*, 60 BUS. LAW. 1547, 1548 (2005) [hereinafter Fox, *Understanding Dura*] (defining a primary market transaction as when an investor buys the stock directly from the company as a part of the company’s initial public offering, and that a secondary market transaction usually does not involve a face to face transaction).

52. *Id.*; *Schlick*, 507 F.2d at 374.

53. See generally *Basic Incorporated v. Levinson*, 485 U.S. 224 (1988) (discussing in-depth the fraud-on-the-market theory).

54. *Id.*

55. *Id.*

formal announcement that such negotiations did in fact exist.⁵⁶ The question was whether a presumption of reliance rather than direct reliance could be applied to the plaintiffs' purchase of the stock.⁵⁷ This fraud-on-the-market theory

[i]s based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company business Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.⁵⁸

The Court stated that reliance on the integrity of the market price could be used to prove reliance instead of the investor relying directly on the company's statements.⁵⁹ In stating the differences between primary and secondary market transactions the court stated,

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.⁶⁰

The Court expanded this theory of reliance because in an efficient market, misrepresentations typically affect a stock's price, and the buyers of stock typically rely on the price as a true indication of value.⁶¹ Additionally, "the

56. *Id.* at 226.

57. *Id.* at 242. The question is whether transaction causation can be presumed in fraud-on-the-market cases. See Merritt B. Fox, *Demystifying Causation in Fraud-on-the-Market Actions*, 60 BUS. LAW 507, 514 (2005) [hereinafter Fox, *Demystifying Causation*].

58. *Basic*, 485 U.S. at 241-42 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

59. *Id.*

60. *Id.* at 244 (quoting *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

61. *Id.* (quoting *Blackie v. Barrack*, 524 F.2d 891, 908 (9th Cir. 1975)).

same causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock."⁶² Therefore, the *Basic* Court determined a rebuttable presumption exists in fraud-on-the-market cases that the integrity of the market sets a true value for a security, and a plaintiff's direct reliance on a company's misrepresentations is not needed in secondary market 10b-5 cases.⁶³ Transaction loss, according to the Court, could be presumed by the integrity of the market.⁶⁴ While the *Basic* Court did not directly address loss causation, the Court transformed the private securities fraud cause of action by allowing an investor to rely on the market valuation of a security rather than the misrepresentation of the company.⁶⁵

Loss Causation Under the Private Securities Litigation Reform Act (PSLRA)

While Congress created a statutory mandate to end securities fraud under the Securities Exchange Act of 1934, Congress did not comment on loss causation until it endorsed the concept in 1995.⁶⁶ Congress enacted the Private Securities Litigation Reform Act (PSLRA) in 1995 to clarify the doctrine of loss causation and the elements of private securities fraud claims.⁶⁷ Section 10b-5 actions are private rights of action and are not legislatively created. They are therefore considered implied causes of action.⁶⁸ PSLRA was enacted in part to reduce the uncertainty created by Congress' lack of oversight regarding this cause of action, and the Act codified the loss causation principle.⁶⁹ The statute in relevant part lays out the loss causation principle: "In any private action arising under this chapter, the plaintiff shall have the burden of proving that the *act or omission* of the defendant alleged to violate this chapter *caused the loss* for which the plaintiff seeks to recover damages."⁷⁰ Therefore, Congress defined loss causation as an "act or omission . . . [which] caused the loss."⁷¹ This language is not self-explanatory and provides little insight into how this clause is to be interpreted.⁷² The House Banking Conference Committee clarified the principal when it ex-

62. *Id.*

63. *Id.* at 250.

64. Fox, *Demystifying Causation*, *supra* note 57, at 514.

65. *Basic*, 485 U.S. at 244.

66. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (1934).

67. S. REP. NO. 104-98, at 683 (1995).

68. *Id.*

69. 15 U.S.C. § 78u-4(b)4 (1995).

70. *Id.* (emphasis added).

71. *Id.*

72. Lawrence A. Steckman & Robert E. Conner, *Loss Causation Under Rule 10b-5 A Circuit by Circuit Analysis: When Should Representational Misconduct Be Deemed the Cause of Legal Injury Under the Federal Securities Laws?*, 1061 P.L.I. 375, 396 (1998).

plained that an adequate example of pleading and proving loss causation would be for the plaintiff “to prove that the price at which [he or she] bought the stock was artificially inflated as the result of the misstatement or omission.”⁷³ Under the conference notes, the artificially inflated purchase price theory is an adequate method under which to plead and prove loss causation.⁷⁴

While the legislative history apparently endorses the artificially inflated purchase price theory to prove loss causation, critics of the artificially inflated purchase price theory point to language in the new damage provision in Section D(e) of the PSLRA that states damage is to be limited to the difference between the purchase price and the mean trading price of the security in the ninety day look back period.⁷⁵ Critics contend the artificially inflated purchase price theory is inconsistent with this ninety-day damage look-back period.⁷⁶ However, this provision does not dictate how damages are to be assessed.⁷⁷ It merely states there is to be a limit on an investors’ damage.⁷⁸ Explaining how the new damage provision is consistent with the artificially inflated purchase price theory, one academic contends,

The issue is the extent to which that misrepresentation or omission created a disparity between the plaintiff’s transaction price and the actual value of securities—on the date of the transaction After, but only after, the disparity between the transaction price and the actual value of the security on the date of the transaction is calculated, should the

73. H.R. REP. NO. 104-369, at 41(1995).

74. *Id.*

75. 15 U.S.C. § 78u-4(e) (Supp. 1997).

Except as provided in paragraph (2), in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

Id. Additionally, the artificially inflated purchase price theory contends that an investor realizes economic damage by buying a stock that is priced higher than its true value due to the fraudulent activity of the company. See *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627, 1630 (2005) (discussing the artificially inflated purchase price theory in depth).

76. Escoffery, *supra* note 31, at 1818-19.

77. 15 U.S.C. § 78u-4(e) (Supp. 1997).

78. *Id.*

parties and their expert consider the impact of the 'cap' on that otherwise accurate measure.⁷⁹

Therefore, the PSLRA limits the amount of damages an investor can receive by tying damages to the mean average of the look back period, but the PSLRA does not limit damages to a subsequent drop in a stock's price.

Circuit Courts' Interpretation of Loss Causation

Despite the PSLRA interpretation of the artificially inflated purchase price theory, the circuit courts have split on the issue of whether an artificially inflated purchase price is sufficient to plead and prove loss causation.⁸⁰ Two circuit courts, the Ninth Circuit and the Eighth Circuit, have determined that loss causation can be pled and proven through the artificially inflated purchase price theory.⁸¹ In *Knapp v. Ernst & Whitney*, investors purchased shares of ATV Corporation during the Initial Public Offering (IPO).⁸² The investors claimed that Ernst and Whitney should have included a "going concern" statement in its audited financial statements, and because it did not, the investors were misled as to the financial status of the company.⁸³ Ernst claimed that the district court erred in issuing a jury instruction stating loss causation can be found where "there were material misrepresentations and/or omissions which caused the market price of ATV stock purchased by the class members to be higher than it would have been if all

79. Escoffery, *supra* note 31, at 1819 (quoting MICHAEL J. KAUFMAN, SECURITIES LITIGATION: DAMAGES § 1B:07 (1999)).

80. See *Knapp v. Ernst & Whitney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (holding that an inflated purchase price was sufficient to plead and prove loss causation); *Gebhart v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003) (holding that an inflated purchase price was sufficient to plead and prove loss causation). *But see* *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000) (holding that an inflated purchase price is legally insufficient to plead and prove loss causation); *Robbins v. Koger Properties*, 116 F.3d 1441 (11th Cir. 1997) (holding that an inflated purchase price is legally insufficient to plead and prove loss causation).

81. *Knapp*, 90 F.3d at 1438. A securities price has long been determined by the company's estimated future cash flows discounted back to the company's present cost of capital. *Robbins*, 116 F.3d at 1448. The value of a company is often calculated by determining the present value of future cash flows. Jay W. Eisenhofer, Geoffrey C. Jarvis & James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 BUS. LAW. 1419, 1421 (2004) [hereinafter Eisenhofer]. This analysis is called the Discounted Cash Flow (DCF) analysis. *Id.* The mathematical valuation is as follows: $V = PV \text{ cash flows} + PV \text{ terminal value}$. Cash Flows = Cash flow forecasted during the projection period. Terminal Value = Value of the stock at the end of the forecast period. PV = Present Value as of the valuation date using the debtor's Weighted Average Cost of Capital (WACC) as the discount rate. *Id.*

82. *Knapp*, 90 F.3d at 1434-35.

83. *Id.* at 1435.

the true facts were known or if you find that ATV's stock would not have been issued."⁸⁴ The Ninth Circuit Court of Appeals concluded, "the district court's instruction, which focused on the reason for the plaintiffs' alleged loss was an accepted statement of loss causation. In a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation."⁸⁵

Similarly, in *Gebhardt v. ConAgra Foods Inc.*, investors brought a class action lawsuit against ConAgra Foods claiming the company engaged in misleading accounting practices and that these misrepresentations caused the investors a loss.⁸⁶ The investors claimed that

the market for ConAgra's common stock promptly digested current information regarding ConAgra from all publicly available sources and reflected such information in ConAgra's stock price. Under these circumstances, all purchasers of ConAgra's common stock . . . suffered similar injury through their purchase of ConAgra's common stock at artificially inflated prices.⁸⁷

The court found that "[p]aying more for something than it is worth is damaging."⁸⁸ Thus, the plaintiffs adequately pled their case for damages.⁸⁹ Because paying more than something's worth can be characterized as "damage," two circuits have reasoned that the artificially inflated purchase price theory is sufficient to plead and prove loss causation.

Other circuit courts have not interpreted the inflated purchase price theory in the same manner.⁹⁰ In *Semerenko v. Cendant Corporation*, the Third Circuit denied the claim that an artificially inflated purchase price was sufficient to plead and prove loss causation.⁹¹ In this case, investors claimed the parent company made misrepresentations about a corporate takeover and the shares of stock were artificially inflated because of these misrepresenta-

84. *Id.* at 1437-38.

85. *Id.* at 1438. *See also* *Wool v. Tandem Computers*, 818 F.2d 1433, 1437 (9th Cir. 1987) (stating that the focus should be on the difference between the purchase price and the value of the stock at the date of purchase).

86. *Gebhart*, 335 F.3d at 826.

87. *Id.* at 831.

88. *Id.*

89. *Id.*

90. *Semerenko v. Cendant Corp.*, 223 F.3d. 165, 185 (3d Cir. 2000). *See also* *Robbins v. Koger Properties*, 116 F.3d 1441 (11th Cir. 1997) (holding that an artificially inflated purchase price is insufficient to plead and prove loss causation).

91. *Semerenko*, 223 F.3d. at 185.

tions.⁹² The court, in advocating its position against the inflated purchase price theory, stated,

Where the value of the security does not actually decline as a result of an alleged misrepresentation it cannot be said that there is in fact an economic loss attributable to that misrepresentation. In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price. Because a plaintiff in an action under § 10(b) and Rule 10b-5 must prove that he or she suffered an actual economic loss, we are persuaded that an investor must also establish that the alleged misrepresentations proximately caused the decline in the security's value to satisfy the element of loss causation.⁹³

Similarly, in *Robbins v. Koger Properties, Inc.*, a group of investors filed a class action lawsuit when the price of KPI stock dropped following a dividend cut.⁹⁴ Investors claimed that Koger and its auditor, Deloitte and Touche, knowingly used unacceptable methods of determining cash flow for its financial statements, therefore artificially inflating the price of Koger's stock.⁹⁵ The Eleventh Circuit stated that the class had failed to plead and prove loss causation because they did not present evidence that the artificially inflated price was removed from the market price, thereby causing a loss.⁹⁶ The Eleventh Circuit essentially demanded to see a drop in the price of the security after the whole truth was made known to the public.⁹⁷ The differences in the circuit courts' holdings, even in light of the PSLRA's acceptance of the artificially inflated purchase price theory, have invariably made it difficult to ascertain the relevant law regarding loss causation.

Damages and Economic Loss

The damages doctrine is critical in ascertaining how the artificially inflated purchase price fits into the loss causation framework because the circuit courts lack a uniform test for determining loss causation. In showing how loss and damage are characterized under the law, the Fourth Circuit explained, "We, along with other courts, use the terms 'injury' and 'damages,' as well as 'loss' and 'harm,' interchangeably to refer to the actual

92. *Id.* at 169.

93. *Id.* at 185.

94. *Robbins*, 116 F.3d at 1445. *See also Semerenko*, 223 F.3d at 185.

95. *Robbins*, 116 F.3d at 1444-46.

96. *See id.* at 1446.

97. *Id.*

pecuniary loss that a private plaintiff must establish to prove liability in a Rule 10b-5 case.”⁹⁸ Therefore, the proper methods for pleading and proving loss causation can be determined by identifying how the court calculates damages in a private securities fraud cause of action.⁹⁹

98. David Tabak, *Loss Causation and Damages in Shareholder Class Actions: When it Takes Two Steps to Tango*, 1442 PLI/CORP 181, 192 (2004). See also *Miller v. Asensio & Company*, 364 F.3d 223, 229 (4th Cir. 2004) (stating that many courts use these words interchangeably and are meant to be defined as one and the same).

99. One key development in the calculation of securities fraud damages was the creation of “event studies” to measure the out-of-pocket expenses that were proximately caused by the misrepresentation of a defendant. Eisenhofer, *supra* note 81, at 1425. Judge Sneed of the United States Court of Appeals for the Ninth District pioneered this concept, as he determined that the best way to measure loss caused by a defendant’s misrepresentation is to create a graph featuring both a “price line” and “value line.” *Id.* See also *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1341 (9th Cir. 1976) (stating the best way to measure loss is by graphing a price and value line, and where they differ, a misrepresentation has caused an economic loss). Therefore, by using this chart as a foundation for calculating damages, Judge Sneed proceeded to calculate the damages by subtracting “the true value of the stock on the date of purchase from the price actually paid, with the spread between the price and value lines varying over time.” Eisenhofer, *supra* note 81, at 1425. See also Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 887 (1990) (containing the description of Judge Sneed’s calculations). An event study was then created, which is “a statistical regression analysis that examines the effect of an event on a dependant variable, such as a corporation’s stock price.” Eisenhofer, *supra* note 81, at 1425. See also Jon Koslow, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 FORDHAM L. REV. 811, 822 & n.50 (1991) (stating the purpose and objective of statistical regressions in a damage analysis). This method’s premise is that the stock price and value of the security will move in the same direction except for days in which company disclosures of corporation-specific information is released to the public. Eisenhofer, *supra* note 81, at 1425. The analyst then looks at the days where there are discrepancies between the value of the security and the price of the security. *Id.* After these abnormal return days are spotted, the expert then determines whether the discrepancy is due to fraud or something else. *Id.* Event studies have been used for years by financial analysts to measure the effect of new information relevant to a corporation’s equity valuation on impacted market prices. *Id.* See also Sanjai Bhagat, *The Costs of Inefficient Bargaining and Financial Distress: Evidence from Corporate Lawsuits*, 35 J. FIN. ECON. 221 (1994) (discussing the use of event studies in equity valuation). Therefore, it is no surprise that this methodology has been coined “among the most successful uses of econometrics in policy analysis.” Eisenhofer, *supra* note 81, at 1425. Since its inception, the event study method has been accepted by a majority of courts. *Id.* Often courts require an event study in expert testimony to distinguish between fraudulent and non-fraudulent factors that impact a securities’ price. *Id.* Therefore, event studies have become a strong tool in detecting and proving the causal connection between a defendant’s misrepresentations and

The Supreme Court in the 1900 case of *Sigafus v. Porter* offered the first common law example of a damage calculation in a fraud context.¹⁰⁰ *Sigafus* addressed the issue of damages suffered by a person who was defrauded while purchasing property.¹⁰¹ The Court, in quoting a rule set forth in a prominent securities fraud case of the time, stated,

The loss, in the transaction before us, is the difference between the real value of the stock at the time of the sale and the fictitious value at which the buyer was induced to purchase. His actual loss does not include the extravagant dreams which prove illusory, but the money he has parted with without receiving an equivalent therefor.¹⁰²

While this holding limits the amount of damages an investor can receive, it does recognize that the damage the investor incurred was in paying an artificially inflated price.¹⁰³ This ruling became the basis for damages under the common law fraud rule: "In an action based upon fraud the purchaser is entitled to recover his actual loss measured by the difference between the price he paid and the value of that which he received, determined as of the time of the transaction."¹⁰⁴ Under the common law fraud rule, paying an artificially inflated purchase price creates damage.¹⁰⁵ The federal courts have concluded that "the measure of damages recoverable by one who through fraud or misrepresentation has been induced to purchase bonds or corporate stock is the difference between the contract price, or the price paid, and the real or actual value at the date of the sale, together with such outlays as are attributable to the defendant's conduct."¹⁰⁶ Therefore, under the common law, the damage to be assessed upon the guilty party in a securities fraud case is the difference between the true value of the security and the fraudulently inflated purchase price.¹⁰⁷

the subsequent economic loss. *See generally id.* at 1425 (stating the resourcefulness of event studies).

100. *Sigafus v. Porter*, 179 U.S. 116 (1900).

101. *Id.* at 117.

102. *Id.* at 124 (quoting *High v. Berret*, 23 Atl. 1004 (1892)).

103. *Id.* at 123.

104. *Kaufman v. Mellon Nat'l Bank & Tr. Co.*, 366 F.2d 326, 331 (3d Cir. 1966).

105. *Id.*

106. *Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith*, 303 F.2d 527, 533 (10th Cir. 1962). *See Arthur Merritt, A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 TEX. L. REV. 469, 471-79 (1988) (stating that the relevant damage is the difference between the true value and the inflated share price).

107. *Estate Counseling Serv.*, 303 F.2d at 533.

In a more recent case, *Affiliated Ute v. United States*, the Supreme Court outlined what an investor's damages are in a securities fraud action.¹⁰⁸ In *Affiliated Ute*, Native Americans sought damages against a bank, two of its employees, and the United States.¹⁰⁹ The investors alleged securities fraud violations in connection with the investors' sale of their shares in the corporation that was created to manage their interests in tribal assets.¹¹⁰ The Court held that the damage to the investor "is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct."¹¹¹ In other words, the damage is the difference between the amount the seller actually received for the security and the true value of the security had there been no fraudulent activity.¹¹² This "out-of-pocket rule" is commonly used in cases where a plaintiff has paid an artificially inflated value for shares of a corporation.¹¹³ It is also the technique most commonly used under SEC Rule 10b-5.¹¹⁴ As applied in 10b-5 cases, the out-of-pocket rule is the difference between the transaction price and the value of the security when the shares are purchased.¹¹⁵ Therefore, in securities fraud cases, both the Supreme Court and the SEC have insisted that paying an artificially inflated purchase price can cause an investor's economic damage.¹¹⁶ The *Affiliated Ute* Court's examination of the damages doctrine, specifically that damage is the difference between the fair market value and the price the investors paid, can be compared to the loss causation doctrine to better understand what methods can adequately be used to fulfill the loss causation element of a 10b-5 offense.

Summary of Loss Causation

Simply stated, loss causation is an element of a private securities fraud cause of action and requires an investor to prove that a company's misrepresentation or omission caused the investor economic harm.¹¹⁷ Loss

108. *Affiliated Ute v. United States*, 406 U.S. 128, 155 (1972).

109. *Id.* at 139.

110. *Id.* at 140.

111. *Id.* at 155.

112. See generally *Affiliated Ute*, 406 U.S. at 155 (explaining how the damage assessment can be calculated as the difference between what the seller receives and what they would have received had there been no misconduct).

113. MICHAEL J. KAUFMAN, SECURITIES LITIGATION: DAMAGES § 1B:07 (1999) [hereinafter KAUFMAN]. See also HAZEN, *supra* note 34, at 15-16 (discussing how the out-of-pocket method is frequently used when a stock's price has been artificially inflated).

114. KAUFMAN, *supra* note 113, at 13.

115. *Id.*

116. *Affiliated Ute*, 406 U.S. at 155; see also KAUFMAN, *supra* note 113, at 13 (stating that the artificially inflated price creates economic damage).

117. See 15 U.S.C. § 78u-4(b)4 (1995) (stating loss causation as an element of the offense).

causation's common law roots led to a lack of clarity regarding its requirements, and in 1995 Congress enacted the PSLRA and defined loss causation as when an act or omission causes the loss.¹¹⁸ While this definition is inherently ambiguous, Congress explained in its committee notes that the artificially inflated purchase price theory would sufficiently plead and prove loss causation.¹¹⁹ However, a split developed amongst the circuits whether an artificially inflated purchase price can adequately plead and prove loss causation.¹²⁰ The courts' inconsistency has led to uncertainty and ambiguity in both defining and applying the loss causation principle in a private securities fraud cause of action.

PRINCIPAL CASE

The Supreme Court, in the Spring of 2005, issued its seminal decision regarding the loss causation requirement in a Rule 10b-5 action.¹²¹ The Supreme Court granted certiorari in the case of *Dura Pharmaceuticals v. Broudo* to decide whether loss causation can be pled and proven by the inflated purchase price theory when the offending party made material misrepresentations.¹²²

Can an Artificially Inflated Purchase Price Prove Loss Causation?

The Court's analysis of the loss causation doctrine began by looking at the historical beginnings of a private securities fraud cause of action. The Court examined the statutory provisions from the Securities Exchange Act of 1934 to try and ascertain the historical purpose of this implied private right.¹²³ The Court explained that "section 10(b) of the Securities Exchange Act of 1934 forbids (1) the 'use or employ[ment] . . . of any . . . deceptive device,' (2) 'in connection with the purchase or sale of any security,' and (3) 'in contravention of' Securities and Exchange Commission 'rules and regulations.'"¹²⁴ Furthermore it explained, "[c]ommission Rule 10b-5 forbids, among other things, the making of any 'untrue statement of material fact' or

118. 15 U.S.C. § 78u-4(b)(4) (1995). See also S. REP. NO. 104-98, at 683 (1995) (noting the lack of Congressional oversight led to a lack of clarity regarding the requirements of loss causation).

119. H.R. REP. NO. 104-369, at 41 (1995).

120. See *Semerenko v. Cendant Corp.* 223 F.3d 165, 185 (3d Cir. 2000) (holding that an inflated purchase price is legally insufficient to plead and prove loss causation); *Robbins v. Koger Properties*, 116 F.3d 1441 (11th Cir. 1997) (holding that an inflated purchase price is legally insufficient to plead and prove loss causation).

121. Jonathan C. Dickey, *Current Trends in Federal Securities Litigation*, (ALI-ABA Course of Study, July 7-9, 2005) WL SL020 ALI-ABA 891, 896.

122. *Dura*, 125 S. Ct. at 1629 (addressing the holding set forth by the Ninth Circuit in *Dura*, 339 F.3d at 938).

123. *Dura*, 125 S. Ct. at 1630-31.

124. *Id.* (quoting 15 U.S.C. §78j(b) (1934)).

the omission of any material fact ‘necessary in order to make the statements made . . . not misleading.’”¹²⁵ The Court interpreted these statutes to imply that this implied private damages action mimics common-law tort actions for misrepresentation and deceit.¹²⁶ The Court explained that the elements of a 10b-5 cause of action include a material misrepresentation, scienter, a connection with the purchase or sale of a security, reliance, economic loss and loss causation.¹²⁷

After ascertaining the elements of a 10b-5 offense, the Court then focused on the loss causation element and what methods might properly be implemented to properly plead and prove this principle.¹²⁸ The *Dura* Court stated that the Ninth Circuit’s interpretation of the law regarding loss causation was incorrect.¹²⁹ The Court maintained that as a matter of logic, there is not any “loss” at the time of purchase because the inflated purchase price is offset by the ownership of a share that simultaneously possesses the equivalent value.¹³⁰ The Court stated that this is because the foundation of financial markets is not a simultaneous appreciation of an investment; rather, investments are usually keyed toward a future gain.¹³¹ The Court reasoned that if a shareholder sells her position prior to public findings of a misrepresentation, no loss will accrue.¹³² Therefore, the Court stated that an inflated purchase price theory at best says that the company’s misrepresentation “touches upon” a latter economic loss.¹³³ However, the Court explained that to touch upon a loss is not the same as causing an economic loss.¹³⁴ In the eyes of the Court, at best, an artificially inflated purchase price *might* lead to a later economic loss.¹³⁵ Furthermore, the Court stated that any link between the inflated purchase price and a later economic loss is too strained since many other factors may affect the stock’s price.¹³⁶ The Court stated that although fraudulent representations might, in part, lead to the depreciation of

125. *Dura*, 125 S. Ct. at 1631 (quoting 17 CFR § 240.10b-5 (2004)).

126. *Dura*, 125 S. Ct. at 1631.

127. *Id.* The Court in *Dura* references the following: *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988) (material misrepresentation); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (scienter); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975) (a connection); *Basic*, 485 U.S. at 248-249 (reliance); 15 U.S.C. 78u-4(b)(4) (1995) (economic loss); T. HAZEN, LAW OF SECURITIES REGULATION, §§ 12.11[1], [3] (5th ed. 2002) (loss causation).

128. *Dura*, 125 S. Ct. at 1631.

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.* at 1632.

133. *Id.* See also *Dura Pharmaceuticals v. Broudo*, 339 F.3d 933, 938 (9th Cir. 2003).

134. *Dura*, 125 S. Ct. at 1632.

135. *Id.*

136. *Id.*

the security, other factors might lead to the demise in greater proportion.¹³⁷ The Court cited changed economic circumstances, changed investor expectations, and new industry-specific or firm-specific facts, conditions, or other events as circumstances that might invariably lead to the depreciation of a security.¹³⁸

The Court then asserted that the position taken by the Investors lacked the weight of judicial precedent.¹³⁹ The Court explained that by analyzing the common law roots of securities fraud, it became clear that an investor must suffer an economic loss in addition to the fact the investor would not have purchased the security if he or she had known the truth.¹⁴⁰ The common law requires a person who fraudulently makes a misrepresentation liable for pecuniary loss caused to one who justifiably relies upon that misrepresentation.¹⁴¹ The Court relied on the Restatement of Torts when it stated “[that a person who] ‘misrepresents the financial condition of a corporation in order to sell its stock’ becomes liable to a relying purchaser ‘for the loss’ the purchaser sustains ‘when the facts . . . become generally known’ and ‘as a result’ share value ‘depreciate[s].’”¹⁴²

Finally, the Court held the Ninth Circuit overlooked the historical objectives and implications of securities law.¹⁴³ The Court claimed that while Congress intended to allow private securities fraud actions, it clearly intended for these plaintiffs to allege and prove the traditional elements of causation and loss.¹⁴⁴ Additionally, the Court stated the securities statutes attempt to maintain public confidence in the investment marketplace.¹⁴⁵ However, according to the Court, Congress did not intend to provide investors an insurance policy against market losses, but to protect them from the misrepresentations that actually cause economic loss.¹⁴⁶ The Court ex-

137. *Id.* Under this traditional loss causation approach, the investor is susceptible to the full downside risk of negative news, while simultaneously not realizing full upside risk associated with positive news because any such gains can be offset by the market realization of the truth. Fox, *Demystifying Causation*, *supra* note 57, at 521-22.

138. *Dura*, 125 S. Ct. at 1632.

139. *Id.*

140. *Id.* at 1633.

141. *Id.*

142. *Id.* (quoting RESTATEMENT SECOND OF TORTS § 548A, cmt. b (2005)).

143. *Id.*

144. *Id.*

145. *Dura*, 125 S. Ct. at 1633.

146. *Id.* The Court incorporates this reasoning from the dissent of the *Basic* decision where Justice White and Justice O'Connor stated: "Allowing recovery in the face of affirmative evidence of nonreliance would effectively convert Rule 10b-5 into a scheme of investor's insurance." *Basic*, 485 U.S. at 252. "There is no support in the Securities Exchange Act, the Rule, or our cases for such a result." *Id.*

plained that Congress enacted the legislation to give investors an avenue for relief when injustice had been done, yet loss causation must be pled and proven in a manner other than under the inflated purchase price theory.¹⁴⁷

In addition to examining the Securities Exchange Act of 1934, the Court delved into the statutory provisions of the Private Securities Litigation Reform Act of 1995.¹⁴⁸ The Court interpreted the statute as requiring securities fraud complaints to “‘specify’ each misleading statement; that they set forth the facts ‘on which [a] belief’ that a statement is misleading was ‘formed’; and that they ‘state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.’”¹⁴⁹ The Court found the statute shows Congress’ intent to permit recovery in private securities fraud actions only where elements of causation and loss are proven.¹⁵⁰ Therefore, the Court held that loss causation, a traditional element of a private action, was not met through the inflated purchase price method.¹⁵¹

Did the Investors Adequately Allege Loss Causation?

After determining the artificially inflated purchase price was insufficient to adequately plead and prove loss causation, the second issue the Court examined was whether the plaintiffs, in light of the Court’s decision regarding the first issue of whether an artificially inflated purchase price sufficiently proves loss causation, adequately pled and proved the elements of loss causation and economic loss.¹⁵² The *Dura* Court held the Investors failed in this regard.¹⁵³ The Court acknowledged that under the Federal Rules of Civil Procedure all that is required in the complaint is “a short and plain statement of the claim showing that the pleader is entitled to relief.”¹⁵⁴ However, the “short and plain statement” must adequately give the defendant “fair notice” of the claim and the “grounds upon which it rests.”¹⁵⁵

The Court found that only one short statement in the Investors’ complaint could be interpreted as describing the loss caused by the company’s misrepresentations.¹⁵⁶ This statement contended that the plaintiffs “paid artificially inflated prices for Dura’s securities and suffered dam-

147. *Dura*, 125 S. Ct. at 1633.

148. *Id.*

149. *Id.* (quoting Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4(b)(1)(2) (1995)).

150. *Id.*

151. *Id.*

152. *Id.* at 1634.

153. *Dura*, 124 S. Ct. at 1634.

154. *Id.* (quoting FED. R. CIV. P. 8(a)(2)).

155. *Id.* (quoting *Conley v. Gibson*, 355 U.S. 41, 47 (1957)).

156. *Id.*

age[s].”¹⁵⁷ Essentially, the plaintiffs’ loss was the artificially inflated purchase price paid upon the purchase of the security.¹⁵⁸ The Court noted that nowhere in the complaint did it allege that the securities share price dropped significantly after the truth became known to the public.¹⁵⁹ Because the artificially inflated purchase price theory was held to be an invalid method to plead and prove loss causation, failing to allege a subsequent price drop made the Investors’ pleadings legally insufficient.¹⁶⁰ Furthermore, the Court stated that the complaint did nothing to provide the defendants notice of what the relevant economic loss might entail or the causal connection between the misrepresentation and the loss.¹⁶¹

The Court conceded the Federal Rules of Civil Procedure are not meant to impose a great burden on the complaining party.¹⁶² However, the Court stated it should not be overly burdensome for a plaintiff who has suffered a relevant economic loss to provide the opposing party with some indication of the causal connection between the misrepresentation and the relevant loss.¹⁶³ At the same time, the Court stated its desire to not allow the plaintiffs to forgo giving any type of indication of causation and loss because allowing such pleadings would create a harm that the securities fraud statutes try to avoid.¹⁶⁴ The Court feared the number of groundless claims that would be allowed in if such pleading standards were lowered.¹⁶⁵ Specifically, the Court feared plaintiffs with groundless claims would be able to bypass summary judgment and coax a settlement out of the company before a thorough discovery process had been completed.¹⁶⁶ The Court feared that this would turn a private securities action into a “downside insurance policy.”¹⁶⁷ The Court found the Investors failed to plead anything more than the inflated purchase price theory regarding loss causation, and therefore, the complaint failed to plead and prove the required elements of a private securities action.¹⁶⁸ In sum, the *Dura* Court stated that loss causation and eco-

157. *Id.* (internal quotations omitted).

158. *Id.*

159. *Dura*, 124 S. Ct. at 1634.

160. *Id.*

161. *Id.*

162. *Id.* (referring to FED. R. CIV. P. 8(a) and *Swierkiewicz v. Sorema N. A.*, 534 U.S. 506, 513-515 (2002)).

163. *Id.*

164. *Id.* (referencing H.R. REP. NO. 104-369, at 31 (1995)).

165. *Dura*, 124 S. Ct. at 1634.

166. *Id.* See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, at 741 (stating concern for coaxing settlement before discovery of relevant facts).

167. *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627, 1634 (2005). See *Basic Incorporated v. Levinson*, 485 U.S. 224, 252 (1988) (stating concern over downside insurance policy for investors whose share price falls).

168. *Dura*, 125 S. Ct. at 1634.

conomic loss cannot be pled and proven through an inflated purchase price paid by investors.¹⁶⁹

ANALYSIS

The United States Supreme Court leveled a blow against investors in securities fraud class action lawsuits by holding that an artificially inflated purchase price is insufficient to prove loss causation.¹⁷⁰ However, because the Court failed to endorse any alternative method, investors avoided a potentially damaging ruling that would have effectively required a showing of a drop in a stock's price after a company's corrective disclosure to prove loss causation.¹⁷¹ Additionally, in the Court's pleadings section, investors secured a favorable ruling affirming that investors are not subject to heightened pleadings requirements to effectively plead loss causation.¹⁷² As a result of the Court's failure to discuss alternative methods of proving loss causation, there remains immense uncertainty as to what loss causation approach remains viable.¹⁷³

Proving Loss Causation

In *Dura Pharmaceuticals v. Broudo*, the Court considered the appropriateness of various approaches an investor may utilize in proving loss causation.¹⁷⁴ The first approach, the very reason the Court granted certiorari, was to determine whether the artificially inflated purchase price theory is sufficient to prove loss causation.¹⁷⁵ This approach is the most favorable to investors because all that would be required of the investor is to prove that he or she paid an amount higher than the true value of the stock at the time of purchase.¹⁷⁶ The second approach is the one advocated by both *Dura* and

169. *Id.* at 1633-34.

170. *Id.* at 1631.

171. *Id.* at 1634; *see also* Brief for the United States as Amici Curiae Supporting Petitioners at 15, *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627 (2005) (No. 03-932) [hereinafter United States Brief] (noting that the United States advocated for a position that would have required a corrective disclosure).

172. *Dura*, 125 S. Ct. at 1633.

173. *See* Fox, *Understanding Dura*, *supra* note 51, at 1552 (discussing how the *Dura* Court left open the issue as to what type of allegations and evidence will be sufficient to meet the requirements of its holding).

174. *See* Patrick J. Coughlin, Eric Alan Isaacson & Joseph D. Daley, *What's Brewing in Dura v. Broudo? The Plaintiffs' Attorneys Review The Supreme Court's Opinion and its Import for Securities Fraud Litigation*, 37 LOY. U. CHI. L.J. 1, 2 (2005) [hereinafter Coughlin] (explaining that the Court had a variety of positions to chose from).

175. *Dura*, 125 S. Ct. at 1630.

176. *See generally* Fox, *Understanding Dura*, *supra* note 51, at 1548 (discussing an investor who has paid an inflated price incurred an injury not because it turned

its amici.¹⁷⁷ This position would require that economic loss only be calculated after the misleading company makes a corrective disclosure.¹⁷⁸ This approach is the least friendly to investors, as there is a high probability that the economic loss an investor incurs will be adjusted into the price of the stock prior to the company's disclosure.¹⁷⁹ However, because the Court only dismissed the artificially inflated purchase price theory and failed to comment on other methods, there remain many unanswered questions regarding the appropriateness of these alternative methods.¹⁸⁰ Because each method for proving loss causation is fundamentally different, the most apparent affect of the Court's unwillingness to articulate a sufficient loss causation standard is the uncertainty it created over an investor's damage calculation.

Here is an illustrative example of different loss causation approaches and the resulting damage calculations. Clearly, the Court's failure to expressly adopt a sufficient method to prove loss causation will lead to uncertainty in calculating damages.¹⁸¹ Suppose that ABC Corporation sold a share of stock for \$10. The next day the Corporation misrepresents last quarters' earnings and the price jumps to \$15. Stanley buys the stock at \$15. Suppose that over the next couple of months two events occur: ABC invents the time machine and the public becomes aware of ABC's earnings misstatement. The time machine announcement bumps the price up an additional \$2 while the news about the misstatement lowers the price by the \$5 that it had been inflated. Additionally, one year later, the price of the stock is worth \$5 due to a multitude of other factors, and it is at this time that ABC makes a public, corrective disclosure about its earnings misstatement from a year ago, and the stock reacts by dropping to \$4.75. The reason for the small price decrease at the time of the corrective disclosure is the market already

out to be a losing transaction, but because the price that the investor paid was higher than it would have been but for the misstatement).

177. *Dura*, 125 S. Ct. at 1634; see also United States Brief, *supra* note 171, at 15 (noting that the United States advocated for a position that would have required a corrective disclosure).

178. *Dura*, 125 S. Ct. at 1634.

179. See generally Fox, *Understanding Dura*, *supra* note 51, at 1556 (stating that while the misstatement might have initially inflated the market price of the stock, the market may have realized the true situation prior to company disclosure).

180. See *id.* at 1552 (discussing the *Dura* Court's leaving the issue open as to what type of allegations and evidence will be sufficient to meet the requirements of its holding).

181. For a more complete illustration of the concepts explained in this example see Fox, *Demystifying Causation*, *supra* note 57, at 521-22.

had information pertaining to the misstatement and the price had subsequently reflected this information prior to the official disclosure.¹⁸²

Calculating damages under the artificially inflated purchase price theory is a simple exercise. Under this approach, Stanley's damages would be calculated by taking the difference between the fair and fraudulent value of the stock at the time of purchase. Stanley bought the stock at \$15 when it was only worth \$10, therefore his damage total can be calculated by [$\$15$ (purchase price) - $\$10$ (true value of stock at time of purchase) = $\$5$]. Stanley would therefore be entitled to \$5 in economic loss.

The approach advocated by *Dura* and its amici would require damage to be calculated only after the misleading company makes a corrective disclosure.¹⁸³ Under this approach, the damage Stanley would realize is the amount the price drops immediately after a company's disclosure. This approach renders the following damage calculation: [$\$5$ (price before corrective disclosure) - $\$4.75$ (price after corrective disclosure) = $\$0.25$]. Stanley would therefore be entitled to \$0.25 in damages.

Because the Supreme Court failed to expressly adopt any specific method for proving loss causation, the lower courts will inevitably be asked to sort through a multitude of approaches that will lead to a lack of certainty and uniformity in calculating an investors' damages.¹⁸⁴ For example, some courts may require an investor to show a drop in the price of a security immediately after the market becomes aware of ABC's misstatement. Under this approach, Stanley would only be privileged to the amount that the share dropped below its original purchase price. Therefore Stanley's damage calculation would look like this: [$\$15$ (purchase price) - $(\$15 + \$2(\text{time machine appreciation}) - \$5(\text{misstatement depreciation})) = \3]. Stanley would be entitled to \$3 worth of damages. However, this approach results in bad financial policy because Stanley is forced to incur the full downside risk associated with bad news, while simultaneously not benefiting from the full upside potential of good news.¹⁸⁵ This disparate effect is unfair to a prudent investor who correctly anticipates ahead of market news, and deviates from the well-settled securities regulation policy of protecting an investor's ex-

182. See Fox, *Understanding Dura*, *supra* note 51, at 1556 (stating that while the misstatement might have initially inflated the market price of the stock, the market may have realized the true situation prior to company disclosure).

183. See United States Brief, *supra* note 171, at 15 (noting that the United States advocated for a position that would have made it difficult for investors).

184. See Fox, *Understanding Dura*, *supra* note 51, at 1554-66 (discussing how the *Dura* Court's failure to articulate a standard rule will force the lower courts to evaluate different approaches regarding different fact patterns and a multitude of variables).

185. See Fox, *Demystifying Causation*, *supra* note 57, at 521 (discussing the disparate effect of good and bad news on an investor's damage calculation).

pectations.¹⁸⁶ Normally, at the time of purchase, an investor would expect to incur both full upside and downside risk; however, the declining price approach fails in this regard. In addition, other courts may wish to continue using the approach advocated by *Dura* and its amici. As stated earlier, under this approach Stanley would only be entitled to \$0.25 in damages. This illustration demonstrates how similarly situated investors will receive different damages depending upon the method used in a particular jurisdiction and raises the question as to how different variables will impact an investor's damages calculation.¹⁸⁷ This disparity and resulting uncertainty are a direct result of the *Dura* Court's inability to articulate a fair, functional, and acceptable standard for proving loss causation.

Though the Court failed to adopt a specific method for proving loss causation, the inflated purchase price theory represents sound financial policy because its *ex ante* focus is consistent with "efficiency-oriented economic thinking" that has been the driving force behind the recent development of securities regulation.¹⁸⁸ An *ex ante* approach, such as the inflated purchase price theory, is appropriate in fraud-on-the-market cases because a "defendant's misstatement injures the plaintiff not because it caused him to make a purchase that later, *ex post*, turned out to be a losing transaction, but because, *ex ante*, it caused her to pay a purchase price that is higher than it would have been but for the misstatement."¹⁸⁹ An *ex post* approach is not favorable in the fraud-on-the-market context because in an efficient market, factors other than the original misrepresentation are equally likely to affect the stock's price, creating a myriad of evidentiary problems for defrauded investors.¹⁹⁰

The *Basic* Court recognized the benefits of analyzing a fraud-on-the-market case from an *ex ante* perspective.¹⁹¹ The Court utilized this efficiency-driven approach when it articulated the fundamental principle that a

186. *Id.* at 522.

187. *See Fox, Understanding Dura, supra* note 51, at 1555 (discussing different variables that will affect a court's analysis of which loss causation approach should be adopted: was there a significant drop in the price of a security after a company's public announcement of its statements' falsity or not; did the investor continue to hold his or her shares after the misstatement became known, or did he sell earlier; when did the plaintiff purchase the stock, was it after the misstatement was made or was it later; and was the purchase price higher or lower than the sales price).

188. *Id.* at 1549-50. An *ex ante* approach views a situation from the time of the transaction, whereas an *ex post* approach views the same situation with the benefit of hindsight. *Id.*

189. *Id.* at 1548.

190. *See generally id.* at 1549 (discussing how other factors affect a share's price in an efficient market).

191. *See Basic*, 485 U.S. at 245 (noting the Court's evaluation of the problem at the time of the purchase).

purchaser does not seek to purchase a loss in the form of an inflated price.¹⁹² However, this well-settled principle runs contrary to the *Dura* Court's finding that a loss cannot occur at the time of transaction.¹⁹³ This disparity can be attributed to the *Dura* Court's rationalization of its position from an *ex post* perspective. By evaluating the problem in this fashion, the *Dura* Court found itself struggling to determine loss as this is increasingly more difficult the further away one gets from the time of purchase.¹⁹⁴ The Court even admitted its faulty argument by stating that "the lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of the lower price."¹⁹⁵ Utilization of the artificially inflated purchase price eliminates this difficulty as loss can be evaluated at the time of purchase. Therefore, the *Dura* Court made a profound error in denying the viability of the inflated purchase price theory, because evaluating the merits of a fraud-on-the-market cause of action in an *ex post* fashion is severely at odds with modern efficiency-oriented thought.¹⁹⁶

Efficiency minded scholars view situations from an *ex ante* perspective because of "its concern . . . with the law's effect on the . . . incentives of the various actors involved at the time" of purchase.¹⁹⁷ The *Dura* Court, in denying the viability of a method that evaluates the problem from an *ex ante* perspective, hindered Rule 10b-5's policy favoring deterrence.¹⁹⁸ In an *ex ante* analysis, a defendant company is not given the opportunity to circumvent liability under the federal anti-fraud statutes by postponing a corrective disclosure while other factors mitigate any potential damage to the investor.¹⁹⁹ This is because an *ex ante* analysis evaluates loss at the time of purchase, and subsequent happenings are essentially irrelevant. Under the artificially inflated purchase price theory, corporate wrongdoers are foreclosed from concealing malfeasance after the time of purchase and the theory thereby promotes Rule 10b-5's goal of deterring fraudulent activity.

In addition to representing unsound financial and public policy, the Supreme Court deviated from settled precedent in holding that an artificially inflated purchase price is insufficient to prove loss causation. In a 10b-5

192. *Id.* (quoting *Blackie v. Barrack*, 524 F.2d 891, 908 (9th Cir. 1975)).

193. *Dura*, 125 S. Ct. at 1631.

194. *Id.* at 1632.

195. *Id.*

196. See Fox, *Understanding Dura*, *supra* note 51, at 1549 (discussing that an *ex ante* approach is consistent with efficiency-oriented thought).

197. *Id.*

198. *Id.* at 1550 (discussing that the public policy aim of the rules is to deter corporate malfeasance).

199. See Coughlin, *supra* note 174, at 26 (discussing how defendants who perpetrate fraud are also likely to conceal the fraud).

cause of action, the Supreme Court has long recognized the out-of-pocket rule that the difference between the price paid and the value of the security is the appropriate damage calculation.²⁰⁰ This method was adopted by the United States Supreme Court in *Affiliated Ute* when the Court expressly stated that damage in a securities fraud case “is the difference between the fair value of all that the seller received and the fair value of what he would have received had there been no fraudulent conduct.”²⁰¹ The damage endorsement in *Affiliated Ute* is critical in determining what can sufficiently prove loss in the context of loss causation because according to the Fourth Circuit, “loss” and “damage” are used synonymously.²⁰² This out-of-pocket method uses the inflated purchase price of a security as a benchmark from which the true value of the security is to be subtracted.²⁰³ The *Affiliated Ute* Court did not suggest that in proving causation plaintiffs would have to establish a post-transaction decline in the value of their investment.²⁰⁴ Why should calculating “loss” under the “loss causation” framework deviate from settled precedent? By not allowing an investor to realize damage at the time of purchase, the Court undermines the simplicity of its holding in *Affiliated Ute*.²⁰⁵ The Supreme Court has stated that a court should not accept a new test that does not produce greater clarity or simplicity when an existing practice has reasonably served as precedent for a number of years.²⁰⁶ Therefore, the Court failed to properly reconcile the holding of *Affiliated Ute* with its dismissal of the artificially inflated purchase price theory because the *Affiliated* Court stated that an inflated purchase price is the proper benchmark to calculate loss, and the simplicity of the Court’s method should not be disturbed.²⁰⁷

In addition to the lack of deference by the *Dura* Court to the holding of *Affiliated Ute* and the *ex ante* rationale of *Basic*, the *Dura* Court failed to recognize the PSLRA’s legislative history. The language regarding loss

200. Mark A. Olson, *Detecting Financial Reporting Fraud and Understanding Insolvency Risks*, 1439 PLI/CORP 645, 654 (2004). See also KAUFMAN, *supra* note 113, at 13 (discussing the relevancy of the out-of-pocket method); *Affiliated Ute*, 406 U.S. at 155 (stating that the relevant damage is the difference between the true value and the inflated value).

201. *Affiliated Ute*, 406 U.S. at 155.

202. Tabak, *supra* note 98, at 192; see also Miller v. Asensio & Company, 364 F.3d 223, 229 (2004) (stating that many courts use these words interchangeably and are meant to be defined as one and the same).

203. Tabak, *supra* note 98, at 192.

204. Michael J. Kaufman, *Exposing A Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357, 373 (1991).

205. *Affiliated Ute*, 406 U.S. at 155.

206. Jerome B. Grubart, Inc. v. Great Lakes Dredge and Dock Co., 513 U.S. 527, 554 (1995).

207. *Affiliated Ute*, 406 U.S. at 155.

causation, in the PSLRA, is undeniably ambiguous. The statute states that loss causation occurs when a misrepresentation causes the loss.²⁰⁸ The Supreme Court has stated that “one naturally would expect legislative history to confirm” a statute’s meaning.²⁰⁹ The *Dura* Court, while looking at the text of the statute, failed to examine the legislative history concerning whether an inflated purchase price could adequately plead and prove loss causation. The House Banking Conference Committee explained that an adequate example of pleading and proving loss causation would be for the plaintiff “to prove that the price at which [he or she] bought the stock was artificially inflated as the result of the misstatement or omission.”²¹⁰ If the Court would have taken this necessary step, it would have found that the House Banking Committee’s note expressly endorses the artificially inflated purchase price method as a valid method to plead and prove loss causation.²¹¹ The Supreme Court continually has required courts to give effect to the expressed intent of Congress.²¹² By failing to properly ascertain the purpose and intent of Congress, the *Dura* Court incorrectly held that an artificially inflated purchase price is insufficient to plead and prove loss causation.

Critics of the artificially inflated purchase price theory contend that the spirit of the PSLRA amendments was to tighten what plaintiffs must plead and prove to establish loss causation.²¹³ Under these critics’ logic, proof under the artificially inflated purchase price theory can be too easily attained to be consistent with the purpose of the statute. Accordingly, this reasoning allows the implied purpose of the statute to override the express intent of the House Banking Committee’s endorsement of the artificially inflated purchase price theory.²¹⁴ While PSLRA was intended to increase the standards investors must meet to adequately plead and prove the securities fraud cause of action, it also was intended to fight securities litigation abuse *without reducing the incentives for filing meritorious claims*.²¹⁵ Under the PSLRA, the loss causation principle is defined as when “an act or omission . . . caused the loss,” and the legislative history makes clear that the artificially inflated purchase price theory is one method that can be used to plead and prove this element.²¹⁶ Therefore, the artificially inflated purchase

208. 15 U.S.C. § 78u-4(b)(4) (1995).

209. *Bourjaily v. United States*, 483 U.S. 171, 187 (1987).

210. H.R. REP. NO. 104-369, at 41 (1995).

211. *Id.*

212. *See Barnhart v. Thomas*, 540 U.S. 20, 26 (2003) (discussing the importance of ascertaining Congressional intent).

213. *Escoffery*, *supra* note 31, at 1819.

214. *See* H.R. REP. NO. 104-369, at 41 (1995) (noting the Committee’s approval of the artificially inflated purchase price theory).

215. S. REP. NO. 104-98, at 10 (1995).

216. *See* 15 U.S.C. § 78u-4(b)(4) (1995) (noting the definition of loss causation).

price theory is consistent with the language of the statute and the intent of Congress.

Critics of the theory also defend their position by contending that because the Senate Report uses the phrase “loss in . . . value of their stock,” this endorses a method that would require a subsequent drop in price.²¹⁷ The critic’s position however is a moot point because the premise of the artificially inflated purchase price theory is that “loss in value” can be calculated at the time of purchase, as the Court in *Affiliated Ute* contended.²¹⁸ Similarly, critics argue against the artificially inflated purchase price theory by stating that it is inconsistent with the new damage provision of the PSLRA requiring damages to be limited to the difference between the purchase price and the mean average of the ninety-day look back period.²¹⁹ The artificially inflated purchase price theory is not impacted by this new damage provision because the investor who uses the post-transaction damage calculation can still assert that the actual injury occurred at the time of purchase.²²⁰ The legislative history clearly states that an artificially inflated purchase price theory is allowable in proving loss causation, while the new damage section is only meant as a limit on those damages.²²¹

Additionally, the only elements under the PSLRA that were subject to increased pleading requirements were falsity and scienter, leaving loss causation subject to standard, liberal pleading requirements.²²² Therefore, because the *Dura* Court failed to properly ascertain the purpose and intent of Congress as stated in the legislative history, the Court improperly held that an artificially inflated purchase price theory is insufficient to plead and prove loss causation.

Policy Against Using the Corrective Disclosure Approach in Future Cases

The Supreme Court concluded that in order for a plaintiff to sufficiently prove loss causation she must show that “the defendant’s misrepresentation (or other fraudulent conduct) proximately caused the plaintiff’s economic loss.”²²³ The Court provided little guidance in defining the sub-

217. See S. REP. NO. 104-98, at 7 (1995) (noting the language used in the report).

218. *Affiliated Ute*, 406 U.S. at 155.

219. Escoffery, *supra* note 31, at 1819 (quoting MICHAEL J. KAUFMAN, SECURITIES LITIGATION: DAMAGES § 1B:07 (1999)).

220. *Id.*

221. See H.R. REP. NO. 104-369, at 41(1995) (discussing the appropriateness of the artificially inflated purchase price theory).

222. See 15 U.S.C. § 78u-4(b)(3) (2000) (noting that sections (b) (1) and (2) address heightened pleading requirements for falsity and scienter, but not loss causation).

223. *Dura*, 125 S. Ct. at 1633.

stantive parameters of this requirement.²²⁴ Instead, the Court only elaborated by stating that a plaintiff could prove loss as "relevant truth begins to leak out" or as "the truth makes its way into the market place."²²⁵ By adopting this policy, the Court recognized there are a number of ways fraud can cause losses other than by a corrective disclosure.²²⁶ The Court expressly stated that a plaintiff needs only to provide the defendants with "some indication" of the connection between the leakage and the economic loss.²²⁷ Some examples of proving loss without corrective disclosure are subsequent price increases and manipulated earnings projections, passage of time, leakage and market reactions, and concealment issues.²²⁸ These methods of proof are most likely the methods that the Court will endorse in the future to sufficiently prove loss causation.²²⁹

Subsequent price increases and manipulated cash flows are often used to control a stock's price in a positive or negative direction.²³⁰ Therefore, it is possible for an investor to suffer economic loss when the value of the stock is greater than when he purchased the shares.²³¹ Positive market information concerning the company that is released simultaneously with the "leakage" may outshine the negative manipulation news and the investor will nonetheless suffer loss, even though he or she has accrued a net gain in the price of his security.²³² Contrarily, just as a company can manipulate its earnings to inflate the price of the stock, the company can manipulate earnings to reduce fraud-induced inflation without a corrective disclosure.²³³ This is referred to as "walking down" the fraud.²³⁴ This can be done by the

224. Coughlin, *supra* note 174, at 15.

225. *Dura*, 125 S. Ct. at 1631-32.

226. Coughlin, *supra* note 174, at 22 (stating that a plaintiff only needs to provide the defendant with some indication of the connection between the leakage and the plaintiff's claimed economic loss).

227. Transcript of Record at 33, *Dura*, 125 S. Ct. 1627 (No. 03-932).

228. Coughlin, *supra* note 174, at 22-26.

229. *See generally id.* at 22 (stating that the Supreme Court recognizes economic loss can be evaluated in a number of ways other than corrective disclosure).

230. *Id.* at 23. Coughlin states, "Market valuations are based upon expected future cash flows discounted by the cost of capital. These cash flows are often referred to as discounted cash flows." *Id.* *See also* RICHARD A. BRESLEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 67-72, 78 n.1 (1983) (analyzing valuation techniques with stock inflation).

231. Coughlin, *supra* note 174, at 23.

232. *Id.* at 22.

233. *See generally id.* at 22 (stating that manipulations can be made to a company's expected cash flows to reduce the value of the stock). One example of possible "leakage" outshining the release of negative manipulation news would be when ABC company announces the invention of the time machine simultaneously with the market's realization of the company's manipulation, resulting in a net price increase, when in reality, the investor has been defrauded by the manipulation. *Id.*

234. *Id.* at 26.

selective disclosure of bad, unrelated news, and thereby avoiding a sudden and dramatic decrease in stock price.²³⁵ Had the Court specifically endorsed the corrective disclosure method, “walking down” the price would have insulated perpetrators from liability because the economic loss would have already been dampened by the “bad news.”²³⁶ Therefore, practitioners and investors must be cautious when evaluating economic loss because economic loss often is overshadowed by an increase in the price of the security and because companies can cover their fraudulent actions of inflating a stock’s worth by subsequently decreasing the effect of their fraud by fraudulent negative cash flow manipulation.²³⁷

The effect of time can also dissipate the effect of a corporation’s security manipulations.²³⁸ Commonly, investors use recent earnings estimates to formulate future expected cash flows.²³⁹ Therefore, as the time between the present and the time of the manipulation grows further apart, the less likely market disclosure will severely impact the price of the stock.²⁴⁰ As one academic contends, “the lack of a visceral, dramatic stock decline accompanying that final disclosure does not mean that the ‘truth’ has not leaked into the market during the ensuing years.”²⁴¹ By proving that the leaking of truthful information to the marketplace created economic damage, an investor may be able to satisfy the loss causation element within the terminology used by the Court in *Dura*.²⁴² Therefore, “[r]ecover should not be denied merely because the defendants managed to conceal their fraud until after the company failed and its stock became worthless.”²⁴³

By failing to adopt the corrective disclosure approach, the Court properly identified the markets are sufficiently efficient to reflect company

235. *Id.* An example of “walking down” the fraud would be a company releasing earnings projections that are lower than they really are in an attempt to conceal the fraud in incremented steps instead of a one time market disclosure of the original manipulation. *Id.*

236. *Id.* See also *supra* notes 198-200 and accompanying text (discussing that the inflated purchase price theory supports sound public policy because it prevents a defendant from walking down the price).

237. See generally Coughlin, *supra* note 174, at 21-27 (discussing alternate methods of correcting fraud and methods for determining loss in ways other than corrective disclosure).

238. *Id.* at 23-24. See also *supra* text note 195 and accompanying text (noting the difficulty in ascertaining loss as time passes).

239. Coughlin, *supra* note 174, at 24.

240. *Id.*

241. *Id.*

242. See generally *id.* (noting that market leakage is an effective way of proving loss in a way other than by corrective disclosure).

243. *Id.* at 25.

news before formal disclosure is announced.²⁴⁴ Investors must take into account that rumors or other information might create economic loss on a piecemeal basis over an undisclosed time span.²⁴⁵ Economic loss therefore might string over several years, making it difficult to properly ascertain the loss that is attributable to the misrepresentation.²⁴⁶ When formal announcement of the fraud becomes public, the impact of this news might be immaterial because the market had already taken into account the possible fraud.²⁴⁷ Under the Supreme Court's analysis in *Dura*, the ultimate non-reaction by the market is immaterial because the earlier leaks are sufficient to prove loss causation.²⁴⁸

Loss Causation is not Subject to Heightened Pleading Requirements

The Supreme Court confirmed in its opinion that in pleading loss causation, a plaintiff was not subject to the heightened pleading requirements set forth for other elements of the 10b-5 offense by the PSLRA.²⁴⁹ This was a win for investors as plaintiffs did not face enhanced pleading burdens, but were subject only to those already stated in the Federal Rules of Civil Procedure.²⁵⁰ According to the Federal Rules, the plaintiff must provide a "short and plain statement" of the loss she alleged and how the defendants caused it, and the statement must be sufficient to provide the defendant with "fair notice" of the claims leveled against him.²⁵¹

This position lies in stark contrast to that advocated by *Dura* and its amici.²⁵² *Dura* argued that loss causation must be pled with particularity.²⁵³ However, this position is contrary to the language and purpose of the PSLRA amendments. Section 21D(b) of the PSLRA states that "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief the complaint shall state with particularity all facts on which that belief is

244. JAMES H. LORIE, PETER DODD & MARY HAMILTON KIMPTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 100-02 (2d ed. 1985).

245. Coughlin, *supra* note 174, at 25.

246. *See generally id.* at 26 (noting that time makes the connection between loss and misrepresentation more attenuated).

247. *Id.*

248. *Id.*

249. *Dura*, 125 S. Ct. at 1634.

250. Coughlin, *supra* note 174, at 16.

251. *Dura*, 125 S. Ct. at 1634.

252. Reply Brief of Petitioners at 10-11, *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627 (2005) (No. 03-932) [hereinafter Reply Brief] (arguing that loss causation must be pled with particularity).

253. *Id.*

formed.”²⁵⁴ Similarly, Section 21D(b) requires scienter to be pled with particularity. Section 21D(b) states, “the complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”²⁵⁵ Therefore, according to section B3, “the court shall, on the motion of any defendant, dismiss the complaint if the requirements . . . are not met.”²⁵⁶ The statute never calls for the dismissal of an action at the pleadings stage for failure to plead loss causation with particularity.²⁵⁷

In addition to the clear intent of the PSLRA, the hardships that would exist in pleading loss causation with particularity at the pleadings stage would make the task almost insurmountable.²⁵⁸ In a complex financial market where several factors can impact a stock’s price, in order to obtain a reliable explanation of the misrepresentation’s impact on the company’s stock price, expert opinion is imperative.²⁵⁹ This examination would typically include an event study with regression analysis and would undeniably need facts uncovered during the course of discovery.²⁶⁰ With the PSLRA’s mandated stay of discovery until after the pleadings’ sufficiency is examined, such a full analysis would be impossible to perform at the pleading stage.²⁶¹ The particularity that *Dura* and its amici called for is better left for the proof stage of the proceeding, where these complicated issues may be sorted out by the ultimate fact finder, the jury.²⁶²

The Court properly held that only a short and plain statement was needed to effectively plead loss causation. The Court also emphasized this point by stating, “[I]t should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.”²⁶³ However, it must be noted that the Court’s holding that an artificially inflated purchase price is insufficient to prove loss causation impacts the manner in which an investor must properly plead loss causation. An investor cannot simply plead that an inflated purchase price caused her damage. Instead, the inves-

254. *Id.* §78u-4(b)(1).

255. *Id.* §78u-4(b)(2).

256. 15 U.S.C. §78u-4(b)(3)(A).

257. Coughlin, *supra* note 174, at 18.

258. *Id.* at 19.

259. *Id.*

260. *Id.*

261. *Id.* See also 15 U.S.C. §78u-4(b)(3)(D) (commenting on the stay of discovery for certain aspects of 10b-5 causes of action).

262. Coughlin, *supra* note 174, at 19.

263. *Dura*, 125 S. Ct. at 1634.

tor must show economic loss sometime after the initial purchase of the stock.²⁶⁴

CONCLUSION

The United States Supreme Court in *Dura Pharmaceuticals v. Broudo* explicitly eliminated the artificially inflated purchase price theory from an investor's arsenal in proving loss causation in a 10b-5 cause of action. Economic loss may therefore not be proven at the time of the transaction. However, the Court failed to elaborate on what type of information must be present or what method must be used to effectively prove loss causation, thereby leaving practitioners and investors in the dark as to the type of evidence needed to substantiate such a claim. Because the Court failed in this regard, there will be further disagreement among the circuits in the development of this concept. While the proof stage of loss causation remains ambiguous, the Court effectively clarified what is needed from an investor in pleading loss causation. A plaintiff must supply a "short and plain statement" that effectively gives the defendant "fair notice." At the end of the day, the Court decided in favor of a tie: pleadings for the plaintiffs, proof for the defendants. What remains to be seen is how these concepts will develop in the future.

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