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After *Dura*: Causation in Fraud-on-the-Market Actions

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After *Dura*: Causation in Fraud-on-the-Market Actions

By Merritt B. Fox*

I. CAUSATION IN ACTIONS BASED ON TRADITIONAL RELIANCE.....	834
A. <i>The Origins of the Transaction Causation/Loss Causation Framework</i>	834
B. <i>The Transaction Causation/Loss Causation Framework Fits Traditional Reliance Based Actions Reasonably Well</i>	837
II. CAUSATION IN FRAUD-ON-THE-MARKET CASES.....	839
A. <i>The Difference in Causal Link</i>	839
B. <i>The Transaction Causation/Loss Causation Framework Fits Fraud-on-the-Market Actions Poorly</i>	839
1. <i>Transaction Causation</i>	840
2. <i>Loss Causation</i>	840
C. <i>The Pre-Dura History of the Application of the Transaction Causation/Loss Causation Framework to Fraud-on-the-Market Cases</i>	841
1. <i>Transaction Causation</i>	841
2. <i>Decisions Finding that Price Inflation Constitutes Loss Causation</i>	842
3. <i>Pre-Dura Decisions Finding a Showing of Price Inflation Insufficient to Satisfy the Loss Causation Requirement</i>	843
D. <i>The Supreme Court's Missed Opportunity in Dura</i>	844
III. THE SUPREME COURT'S HOLDING IN <i>DURA</i>	845
IV. ISSUES REMAINING OPEN.....	846
A. <i>Sale Price Above Purchase Price</i>	847
B. <i>Sufficient Pleadings and Proofs at Trial That the Misstatement Caused a Loss</i>	848
1. <i>The First Situation: Price Drops Immediately After the Public</i>	

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<i>Announcement of the Truth While Plaintiff Still Holds Shares</i>	849
2. <i>The Second Situation: Price Does Not Drop Immediately After the Public Announcement of the Truth While Plaintiff Still Holds Shares</i>	850
3. <i>The Third Situation: Price Does Not Drop Immediately After Public Announcement of the Truth and Plaintiff Has Sold Shares Earlier</i>	854
4. <i>The Fourth Situation: Price Drops Immediately After the Public Announcement of the Truth But the Plaintiff Sells Earlier</i>	855
5. <i>Changing the Four Situations to Reflect a Later Purchase</i>	856
6. <i>Class Actions Typically Involve a Mix of These Situations</i>	857
C. <i>Combining the Open Questions</i>	859
1. <i>Revisiting the First Situation</i>	859
2. <i>Revisiting the Second and Third Situations</i>	859
3. <i>Revisiting the Fourth Situation</i>	861
V. <i>THE COURT'S REASONING IN DURA</i>	862
A. <i>An Inflated Price Results in No Loss at Time of Purchase</i>	862
B. <i>No Inevitable Link Between an Inflated Share Price and Later Economic Loss</i>	863
C. <i>The Ninth Circuit Holding Lacks Precedent</i>	864
VI. <i>RESOLVING THE OPEN ISSUES</i>	865
A. <i>Price at Time of Suit Higher than Purchase Price: Limiting Recovery to Actual Losses</i>	866
1. <i>Case Where Misstatement Clearly Inflated Plaintiff's Purchase Price</i>	866
2. <i>Case where it is not Clearly Established that the Misstatement Inflated Plaintiffs' Purchase Price</i>	867
B. <i>Sufficient Pleadings and Proofs at Trial That the Misstatement Caused a Loss</i>	867
C. <i>The Relevance of the PSLRA</i>	869
D. <i>Should Fraud-on-the-Market Suits Be Discouraged by a Restrictive Rule of Causation</i>	871
E. <i>The Assumption of Constant Impact</i>	872
VII. <i>CONCLUSION</i>	874

On April 19, 2005, the Supreme Court announced its unanimous opinion in *Dura Pharmaceuticals, Inc. v. Broudo*,¹ concerning what a plaintiff must show to establish causation in a Rule 10b-5 fraud-on-the-market suit for damages. The opinion had been awaited with considerable anticipation, being described at the time of oral argument in

1. *Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627 (2005).

the Financial Times, for example, as the “most important securities case in a decade.”² After the opinion was handed down, a representative of the plaintiffs’ bar lauded it as a “unanimous ruling protecting investors’ ability to sue.”³ A representative of the defendants’ bar equally enthusiastically hailed it as “a significant victory for public companies and others named as defendants in securities fraud cases.”⁴ This Article seeks to ascertain the opinion’s real significance and to provide a framework for resolving the issues that remain open to be decided by future courts. In the tradition of Bob Clark’s treatment of Rule 10b-5 issuer misstatement cases, this framework recognizes that these issues involve difficult tradeoffs that defy perfect solutions.⁵

The Supreme Court’s grant of certiorari in *Broudo v. Dura Pharmaceuticals* came against the backdrop of years of highly confusing lower court decisions concerning what a plaintiff needs to show to establish causation in a fraud-on-the-market suit. This confusion had arisen, I will argue, because the lower courts had tried to analyze causation in fraud-on-the-market cases using the twin concepts of “transaction causation” and “loss causation.” These concepts had been originally developed in connection with causation determinations in cases based on traditional reliance. Traditional reliance-based cases, unlike fraud-on-the-market cases, involve the plaintiff establishing that defendant’s misstatement induced the plaintiff to enter into what has turned out to be a losing transaction. In such cases, transaction causation was satisfied by the very showing of traditional reliance, i.e., that the plaintiff would not have purchased but for the misstatement.⁶ Loss causation in these cases involved, in turn, an additional showing that the purchased security declined in value from what was paid (or was sold at a loss) and that the decline or loss was in some way reasonably related to the falsity of the statement that induced the purchase.⁷ The function of the loss causation requirement, like the function of proximate cause in actions for negligence, was to prevent the wrongdoer from being responsible for all the consequences for which his action was a “but for” cause, i.e., all the losses, however unrelated to the misstatement, that the plaintiff might suffer over time as a result of purchasing this security.

Fraud-on-the-market actions such as *Dura* are very different from traditional reliance-based actions. The plaintiff in a traditional reliance-based action is typically a purchaser involved in either a face-to-face transaction in shares of a non-publicly traded issuer or an IPO. These are the only situations where plaintiffs are likely to be able to show traditional reliance. These are situations where there is no reason to assume that the

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

3. Press Release, Lerach Stoia Geller Rudman & Robbins LLP, Ruling on ‘Loss Causation’ Affirms Investors’ Rights to Damages (Apr. 19, 2005) (on file with author), available at <http://www.lerachlaw.com/lcsr-cgi-bin/mil?temp1=news/articles/dura.html>.

4. Press Release, Latham & Watkins Client Alert 455, Supreme Court in *Dura Pharmaceuticals* Unanimously Endorses “Loss Causation” Requirement in Fraud-on-the-Market Cases 4 (Apr. 28, 2005), available at http://www.lw.com/resource/Publications/_pdf/pub1258_1.pdf.

5. ROBERT C. CLARK, CORPORATE LAW 343-45 (1986). Clark notes the tradeoff between deterring misstatements and protecting innocent shareholders, who are the ultimate source of the compensation paid to the injured parties. Clark describes one approach as being “perhaps . . . the least unpalatable alternative.” *Id.* at 345.

6. See, e.g., *Emergent Capital Inv. Mgmt. v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003).

7. See *infra* Part I.

price is an efficient one. In contrast, plaintiffs in fraud-on-the-market actions such as *Dura* are purchasers in active public secondary markets, where prices can be assumed to be efficient. Fraud-on-the-market actions involve a fundamentally different kind of causal connection between the defendant's misstatement and the plaintiff's injury. The defendant's misstatement injures the plaintiff not because it caused her to make a purchase that later, *ex post*, turned out to be a losing transaction. Rather, it injures her because, *ex ante*, it caused her to pay a purchase price that is higher than it would have been but for the misstatement. The purchase is one that she might well have made even if the defendant had not made the misstatement. This causal connection between the misstatement and an injury in the form of its effect on price at the time the plaintiff enters into the transaction was recognized by the Court when it originally approved fraud-on-the-market actions in *Basic v. Levinson*⁸ almost twenty years ago.

The fraud-on-the-market theory's *ex ante* focus on the price at the time of purchase is, for transactions occurring in efficient markets, what is called for by the modern, efficiency-oriented economic thinking that has been the driving force behind the evolution of securities regulation over the last two decades. Efficiency-oriented thinking considers problems from an *ex ante* perspective because its concern is with the law's effect on the structure of incentives of the various actors involved at the time the plaintiff enters into the transaction. Thus, it is these actors' expectations at the time of the transaction that matters. Other than the inflation in price due to the misstatement, the efficient market hypothesis (EMH) guarantees that the purchase price is a fair one because the other factors affecting price in the future are as likely to increase price as decrease it.⁹ Thus, the injury is the inflation in price at the time of purchase.

The twin concepts of transaction causation and loss causation are reasonably serviceable in helping to determine when causation is, and is not, present in an action for fraud based on traditional reliance. These twin concepts simply do not make sense in an action for fraud based on the fraud-on-the-market theory, however, because of the difference between the two kinds of actions in terms of the causal connections between misstatement and injury. The transaction causation requirement makes no sense in a fraud-on-the-market action since the plaintiff is not required to show that she would not

8. *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (stating that the fraud-on-the-market theory, based on the idea that a material misstatement will affect the plaintiff's purchase price, provides the plaintiff with an alternative way to demonstrate "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury"). The rule in *Basic* applies both to suits by secondary market purchasers in cases of falsely positive statements, and to suits by secondary market sellers in cases of falsely negative statements. This Article assumes throughout a suit by a purchaser based on a falsely positive statement. Everything I have to say here about the causation requirement in positive misstatement cases would, with the appropriate reversals, apply equally to a suit by a seller based on a falsely negative statement.

9. Stated more precisely, the EMH holds that future returns from holding a security will be priced in an unbiased way given all publicly available information. RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 333-41 (8th ed. 2006). Combined with the capital asset pricing model (CAPM), *see id.* at 188-92, the EMH provides that other factors are as likely to add as to subtract from what would be the price predicted on the basis of the return on a completely safe asset, such as U.S. government bonds, plus a premium reflecting the expected return on an investment in the market as a whole and the systematic riskiness of the issuer's shares. Thus, while the EMH does not stand for the proposition that there will be no long-term growth in share prices on average over time, it says that the ordinary investor cannot, on average, make profits by trying to pick particular, unusually attractive stocks based on publicly available information.

have purchased but for the defendant's misstatement. Indeed, often she would have. The typical plaintiff is a member of a class predominantly consisting of portfolio investors who have made impersonal purchases of shares in the secondary market on the NYSE or NASDAQ and may well not have been aware of the misstatement. Alternatively, the plaintiff may have been an index fund. Even if the plaintiff had been aware of the misstatement and was investing speculatively, the misstatement is unlikely to have been decisive in the decision to purchase, since a believable misstatement, while making the stock appear more attractive than it really was, would also have made it commensurately more expensive.

The loss causation requirement makes no sense either in the context of a fraud-on-the-market action because the injury—that the plaintiff paid too much—flows directly from the misstatement. Requiring the defendant to compensate for such an injury presents no danger of providing compensation for risks unrelated to the misrepresentation because the injury is unrelated to anything that happens to price after the purchase date. Thus, there is no need for some intervening proximate cause requirement to prevent the defendant from compensating a loss for which its misconduct is a “but for” cause, but which is unrelated in the sense that the misconduct did not increase the risk that the plaintiff would suffer the loss.

Abandoning the transaction causation/loss causation framework would have permitted the Supreme Court, I will argue, to have avoided the confusion exhibited by the lower courts as they struggled to redefine the twin concepts to make them fit the fraud-on-the-market context. By casting this rhetorical baggage aside, the Court could have used the *Dura* case self-consciously to develop standards concerning what an ex ante analysis suggests are the two main concerns relating to causation in fraud-on-the-market actions. One main concern involves identifying those situations where a misstatement actually did inflate the plaintiff's purchase price and hence create an injury. Rules are needed concerning what the plaintiff must plead and prove, and the acceptable forms of evidence, concerning this question.¹⁰ The other main concern involves how to prevent damages from being paid to the subset of investors who suffer injury by purchasing shares at a price inflated by the misstatement but who recoup this injury in part or in whole by reselling sufficiently quickly that the price at the time of sale is still inflated. Thus, rules are also needed concerning who, at the pleading stage and at trial, has the burden of proof on the question of when the market realized the true situation, thereby dissipating the inflation in price, and what are the acceptable forms of evidence of the occurrence of such realization.

The design of each of these sets of rules has an impact on the extent to which we achieve two important public policy aims. One aim relates to the desirability of enhancing share price accuracy, in particular by deterring corporate misstatements. The other relates to the desirability of limiting the variety of transaction costs associated with civil litigation, including, but not limited to, the costs associated with strike suits. These two aims are in part conflicting. Good design involves minimizing these conflicts to the extent possible and then choosing the appropriate place in the inevitable remaining

10. As will be discussed in more detail in Part IV *infra*, under some circumstances this concern breaks down into two subquestions: did the misstatement inflate share price at some point in time and was it still inflated at the time that the plaintiff purchased?

degree of tradeoff between the two aims.

Unfortunately, the Court in its opinion in *Dura* did not abandon the bifurcated transaction causation/loss causation framework for fraud-on-the-market actions and so it was not able to address these two main concerns in a fully self-conscious way. Rather, as the lower courts had been doing in various differing ways, the Supreme Court redefined the twin concepts to try to make them fit fraud-on-the-market actions. The Court allowed plaintiffs to satisfy the transaction causation requirement by use of Basic's "presum[ption] that the price . . . reflects a material misrepresentation,"¹¹ in other words a presumption that the price is inflated by the misrepresentation. This standard is very different than the "but for the misstatement, the plaintiff would not have purchased" transaction causation standard used in traditional reliance-based cases. As for loss causation, the Court ruled that a mere showing that the price has been inflated by the misstatement is not sufficient.¹² The Court was not specific concerning what kind of additional showing would be sufficient, a void that future courts were left to fill. The argument of this Article is that in doing so, these future courts should be mindful that whatever the legal rhetoric, the rules that they develop are best evaluated in terms of the two main concerns discussed above: how well, and at what cost, they (1) identify those situations where plaintiffs have purchased shares at a price that has genuinely been inflated by a misrepresentation, and (2) avoid payment of damages to the subset of such plaintiffs who recoup their injury by reselling sufficiently quickly that the price is still equally inflated.

This Article develops the foregoing points in more detail. Part I explores the origins of the concepts of "transaction causation" and "loss causation" in Rule 10b-5 fraud cases based on traditional reliance. Part II explores the pre-*Dura* attempts of the lower courts to apply these concepts to fraud-on-the-market theory cases and the opportunity that *Dura* presented to the Supreme Court to clear up the resulting confusion. Part III discusses the history of the *Dura* litigation and the holding in the Supreme Court opinion. Part IV addresses what issues have been definitively decided by the Court in *Dura* and what issues remain open to be decided in future cases. Part V considers to what extent the reasoning used by the Court reaching its decision is useful in determining how these open issues should be resolved. Part VI considers how, from a policy point of view, these open issues should be resolved. Part VII concludes.

I. CAUSATION IN ACTIONS BASED ON TRADITIONAL RELIANCE

A. The Origins of the Transaction Causation/Loss Causation Framework

The twin requirements of transaction causation and loss causation were developed in the context of Rule 10b-5 fraud cases where plaintiffs were able to show traditional reliance. The seminal case defining traditional reliance is the Second Circuit's 1965 opinion in *List v. Fashion Park*.¹³ The district court in *List* found that the plaintiff, with

11. *Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627, 1631 (2005).

12. *Id.*

13. *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965). *List* was a non-disclosure case where the plaintiff claimed injury because an insider stayed silent when he allegedly had a duty to speak, not a case based

regard to one of his allegations, would have purchased even if he had known the true situation.¹⁴ On the basis of this finding, the district court dismissed the claim relating to this allegation. The Second Circuit affirmed.¹⁵ In reaching its decision, the Second Circuit started with a ruling that the requirement in common law misrepresentation cases that the plaintiff show “reliance” “carried over into civil suits under Rule 10b-5.”¹⁶

Citing common law authorities, the court found that “the test of ‘reliance’ is whether ‘the misrepresentation is a substantial factor in determining the course of conduct which results in (the recipient’s) loss.’”¹⁷ The court stated “[t]he reason for this requirement . . . is to certify that the conduct of the defendant actually caused the plaintiff’s injury.”¹⁸ Given the district court’s finding that the plaintiff would have purchased anyway, which the appeals court did not find clearly erroneous, the plaintiff clearly failed the test.

List left an open question. Suppose the plaintiff had been able to show that he would not have purchased had he known the true situation. Would that by itself have been sufficient to establish causation? A positive answer would mean that any person who made a misleading statement in violation of Rule 10b-5 would be liable to anyone who could show that the statement was a “but for” cause of the purchase of a security that subsequently declined in price. The plaintiff would essentially be complaining to the defendant: “You got me into this through your violation and, because I got into it, I suffered a loss for which you should make me whole.” This, however, was not the route chosen by the federal courts in working out the contours of the implied right of action under Rule 10b-5. Over time, a clear requirement developed that for liability to be imposed, a plaintiff basing a claim on a showing that the defendant’s 10b-5 violation impelled her into making a securities purchase must show something more.

The first signs that a showing of something more was required appeared in 1969 in another Second Circuit opinion, *Globus v. Law Research Service, Inc.*¹⁹ In *Globus*, the jury found defendants, who had made misleading statements in violation of Rule 10b-5 in a circular for a stock offering, were liable to plaintiffs, who had presented evidence that they had been attracted by the misleading statements into purchasing some of the offered shares and subsequently sustained a loss. On appeal, defendants argued that the jury instructions on causation were improper and that there was insufficient evidence of causation.²⁰ The jury instructions were that “the plaintiff is required to prove . . . that he or she suffered damages as a proximate result of the alleged misleading statements and purchase of stock in reliance to them . . . [i]n other words . . . that the damage was either a direct result or a reasonably foreseeable result of the misleading statement.”²¹ The court described these as “clear instructions on causation”²² and found that they “were

on an affirmative misleading statement. The court’s analysis, however, drew upon affirmative misleading statement cases in the common law and its definition of reliance has been regularly cited as controlling in subsequent Rule 10b-5 affirmative misleading statement cases.

14. *Id.* at 464.

15. *Id.*

16. *Id.* at 462-63.

17. *Id.* at 462 (citations omitted) (emphasis added).

18. *List*, 340 F.2d at 462.

19. *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969).

20. *Id.* at 1291.

21. *Id.*

22. *Id.*

sufficient to bring home the basic concept that causation must be proved else defendants could be held liable to the world.”²³ As for the evidence, the appeals court observed that the plaintiffs not only introduced evidence that the statements were a “but for” cause of the purchases, but that the jury could infer that the stock price was bloated as a result of the statement. The court held that this “was sufficient . . . to support a finding of [a] causal relationship between the misrepresentation and the losses appellees incurred when they sold.”²⁴ Thus, while the court did not explicitly say that a showing of more than just traditional reliance was required, it did, in response to a defendant’s argument that more needed to be shown, approvingly recite jury instructions that appeared to call for a showing of more and point to evidence suggesting the existence of more than just “but for” causation.

Five years later, in *Schlick v. Penn Dixie*,²⁵ the Second Circuit moved one step further toward a clear requirement that a plaintiff who bases a claim on a showing that the defendant’s 10b-5 violation impelled her into making a securities purchase must show something more. Introducing for the first time into the case law the terms “loss causation” and “transaction causation,” the court stated in dicta:

This is not a case where the 10b-5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concededly there would have to be a showing of both loss causation—that the misrepresentations or omissions caused the economic harm—and transaction causation—that the violations in question caused the appellant to engage in the transaction in question.²⁶

It added, however, that the something more that needed to be shown, what it termed “loss causation,” was “rather easily [shown] by proof of some form of economic damage.”²⁷ Finally in 1981, the Fifth Circuit provided a clear appellate court ruling that a showing of something more was required. In *Huddleston v. Herman & MacLean*, the court, in finding that the trial court’s failure to submit issues of reliance and causation to the jury required a new trial, stated:

The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment’s decline in value.²⁸

The *Huddleston* court links these two requirements to the transaction causation/loss causation language used by other courts.²⁹

23. *Id.* at 1292.

24. *Globus*, 418 F.2d at 1291-92.

25. *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974).

26. *Id.* at 380. The crux of the complaint was based on a “corporate mismanagement theory” that there was a scheme to defraud in violation of Rule 10b-5 based on “market manipulation and a merger on preferential terms” in connection with the purchase or sale of a security. *Id.* at 381.

27. *Id.* at 380.

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

29. The court in *Huddleston* said that courts sometimes consider reliance to be a component of causation and that “the term ‘transaction causation’ is used to describe the requirement that the defendant’s fraud must

B. The Transaction Causation/Loss Causation Framework Fits Traditional Reliance Based Actions Reasonably Well

The twin requirements of transaction causation and loss causation are now firmly established.³⁰ In the context of an action based on traditional reliance, their meanings are fairly settled. Transaction causation involves a showing that the plaintiff would not have purchased but for the misstatement.³¹ Loss causation in this context follows on from this first showing. It involves the additional showing that the purchased security declined in value from what was paid (or was sold at a loss) and that the decline or loss was in some way reasonably related to the falsity of the statement that induced the purchase.³² These twin requirements fit neatly within traditional reliance based actions and in this context have a reasonably sensible rationale. The objection to imposing liability based on a showing of transaction causation alone is the same as it would be to imposing liability for every injury for which an act of negligence is a “but for” cause. As every first-year law student learns, the chain of “but for” results flowing from any act of negligence can go on forever and ultimately encompass an infinite number of injuries. For most or all of these injuries, it would be ridiculous to hold the actor responsible. Thus, a showing of something more than “but for” causation is required. In tort, the “something more” is proximate cause. In Rule 10b-5 misleading statement cases based on traditional reliance, the “something more” is loss causation. In each case, the “something more” involves, at a minimum, a showing that the wrongful act somehow raised the probability that the plaintiff would suffer a loss of the kind that she did in fact suffer.

There is also a reasonable, though not quite as compelling, rationale for the requirement that the loss be in the form of a sale at a lower price than the plaintiff paid (or, if the plaintiff still holds the security at the time suit is brought, a decline in the market price from the price paid) rather than in the form of the amount extra that the plaintiff paid as a result of the misstatement. The rationale involves an ex post perspective rather than the ex ante perspective that is characteristic of modern, economics-based securities law analysis.³³ It relies on the observation that being induced by a misstatement into making a securities purchase does not by itself inherently mean that the purchaser will ultimately be worse off. The inducement simply puts the purchaser in a position to enjoy all kinds of possible gains and suffer all kinds of possible losses. If the purchaser ultimately does realize a loss and the loss is one that would have been predictable given knowledge of the true state of affairs, then, the thinking goes, an injury has occurred for which the person who made the misstatement in violation of Rule 10b-5 should be liable.

The critical first step in developing the rationale for this requirement of a loss at sale

precipitate the investment decision” and is “necessarily closely related to” reliance. *Id.* at 549 n.24. “Loss causation,” it continued, “refers to a direct causal link between the misstatement and the claimant’s economic loss.” *Id.*

30. See *Suez Equity Investors v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001) (stating “[i]t is settled that causation under federal securities laws is two-pronged: . . . both transaction causation . . . and loss causation”). For a survey of the cases requiring loss causation, see MICHAEL J. KAUFMAN, *SECURITIES LITIGATION: DAMAGES* § 11:1 (2004).

31. See, e.g., *Emergent Capital Inv. Mgmt. v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003).

32. *Id.*

33. See *infra* Part III.B.

or decline in price is to recognize that an action based on a showing of traditional reliance typically grows out of a face-to-face purchase of shares of a non-publicly traded issuer or a purchase at or about the time of an IPO. In these situations, the price that the plaintiff pays is not one established in an efficient secondary market. As a consequence, the value of the security is much more subjective and the relationship between the misleading statement and the price the plaintiff paid is unclear.³⁴ Unlike what I will contend should be the proper approach with fraud-on-the-market actions, the focus in traditional reliance based actions should not, the argument for the rationale goes, be on the difference created by the misstatement between the price paid and value of the security nor on the effect of the misstatement on the price paid. This is because how low a price, if any, it would have taken for this particular plaintiff to have been willing to buy had she been aware of the truth—the measure of price inflation for this particular plaintiff—is inherently unknowable. The focus instead should be on two facts. First, whatever the value of the security at the time of purchase relative to the price paid, this particular plaintiff would not have purchased at the price offered if she had known the truth. Second, the risks that the truth would have revealed have in fact realized themselves.

It may be easiest to conceptualize the requirement of a loss at sale or decline in price as related to a modified form of rescissory damages. This form of damages is called for because of the special situations that typically give rise to traditional reliance based actions, where the price the plaintiff paid has not been set in an efficient secondary trading market.³⁵ Pure rescissory damages would be the difference between the price paid and the price at which the securities were sold (or, if still held, the price at the time suit was brought). Modified rescissory damages would start with this measure but reduce or eliminate the damages to the extent that the loss or decline was due to factors other than ones related to the false statement. This modified rescissory measure of damages fits nicely with the idea that plaintiff was put by the defendant's wrongful misstatement in the position of potentially suffering losses and that as a result there should be compensation for any losses that in fact do occur, but not if the losses arose from reasons unrelated to the misstatement.

It should be emphasized that this rationale for requiring an ex post loss is driven by the face-to-face or thin market situations that are associated with most traditional reliance

34. As one district court, quoted in *Basic*, put it, “[i]n face-to-face transactions, the inquiry into an investor’s reliance upon information is in the subjective pricing of that information by that investor.” *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980) (quoted in *Basic Inc. v. Levinson*, 485 U.S. 224, 244 (1988)).

35. See Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 361-62 (1984) (discussing modifications to the out of pocket measure of damages needed when there is no ready market for stock or where market price of traded stock does not reflect its actual value at the time of the transaction); LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4414-45, 4421-22 (2004) (discussing problems with calculating damages in close corporation and thin market situations and the use of rescissory damages). Some of the early Rule 10b-5 misstatement cases even suggest that full rescissory damages are appropriate in these sorts of situations. See *Baumel v. Rosen*, 283 F. Supp. 128, 146 (D. Md. 1968) (calling for equitable rescission in the case where defendant close corporation sold shares to plaintiffs who relied on the corporation’s misstatements); *Esplin v. Hirschi*, 402 F.2d 94, 104-05 (10th Cir. 1968) (stating that plaintiff was entitled to recover the difference between price paid and value at time of discovery of the fraud); *Harris v. Am. Inv. Co.*, 523 F.2d 220, 226-27 (8th Cir. 1975) (same). The modification that damages would be reduced or eliminated to the extent that there were other causes for the loss at sale or decline in price can be regarded as reflecting a concern that full rescissory damages could result in unjustified compensation.

based cases and the special measure of damages that these situations may suggest. It is only logical that in an action for compensatory damages, the form of loss for which we make a causation determination should correspond to the measure of damages. Compensatory damages, after all, are supposed to measure loss. The standard measure of damages in Rule 10b-5 cases is “out of pocket” damages: the extra amount the plaintiff pays because of the misstatement.³⁶ The form of loss that corresponds to this measure of damages is the amount by which the misstatement inflates the price the plaintiff pays. Thus, the particular situations in which traditional reliance based fraud actions arise are what call for the special semi-recissionary measure of damages that, in turn, call for looking for the causes of an ex post injury rather than the causes of an injury at the time of purchase as should be the case with standard Rule 10b-5 cases, including fraud-on-the-market cases.

II. CAUSATION IN FRAUD-ON-THE-MARKET CASES

A. *The Difference in Causal Link*

Fraud-on-the-market actions are distinctly different from actions based on traditional reliance. As discussed above, the plaintiff in a traditional reliance based action needs to show that she would have acted differently but for the wrongful misstatement. At a minimum, this requires that the plaintiff have been aware of the statement. The fraud-on-the-market theory, approved by the Court in 1988 in *Basic v. Levinson*,³⁷ provides the plaintiff an alternative way to demonstrate “the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”³⁸ This alternative is to show that the misstatement caused the price the plaintiff paid at time of purchase to be too high, an effect that can be presumed in the case of a material misstatement by an official of an issuer whose shares trade in an efficient market.

The Court insisted in *Basic* that its ruling maintained the need for plaintiff to show reliance, just in the form of “reliance on the integrity of [the market] price”³⁹ instead of reliance on the misstatement itself. There is a big difference between these two forms of reliance, however. Unlike traditional reliance, the plaintiff no longer needs to show she would have acted differently—i.e., not purchased the security—if the defendant had not made the misstatement.

B. *The Transaction Causation/Loss Causation Framework Fits Fraud-on-the-Market Actions Poorly*

As a result of this difference in causal link, the twin requirements of transaction causation and loss causation fit very poorly with fraud-on-the-market actions. In these actions, the typical plaintiff is a member of a class predominantly consisting of portfolio

36. *Randall v. Loftsgaarden*, 478 U.S. 647, 662 (1986); *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 532 (10th Cir. 1962); *LOSS & SELIGMAN*, *supra* note 35, at 4413-14.

37. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

38. *Id.* at 243.

39. *Id.* at 247.

investors and index funds that have made impersonal purchases of shares in the secondary market on the NYSE or NASDAQ. As noted, the plaintiff need not allege that she relied on the misstatement. Indeed, she may well not even have been aware of it. Even if she were, the misstatement is unlikely to have been decisive in her decision to purchase, since the misstatement, while making the stock appear more attractive than it really is, would also have made it commensurately more expensive. Thus, whether she was aware of the statement or not, she likely would have made the purchase even if the misstatement had not been made, just at a lower price. Consequently, the misstatement is not likely to be a “but for” cause for the purchase. The fact that for most fraud-on-the-market plaintiffs, the defendant’s misstatement is not a “but for” cause for their purchase renders nonsensical both elements of the transaction causation/loss causation framework as developed in traditional reliance based cases.

1. Transaction Causation

Transaction causation, as we have seen, involves a showing that the plaintiff would not have purchased but for the misstatement. Thus, transaction causation is just another name for traditional reliance. If courts were seriously to impose a transaction causation requirement in fraud-on-the-market cases, they would be acting in direct contradiction to *Basic*. The whole purpose of *Basic* was to provide the purchaser in the secondary trading markets, for whom demonstrating traditional reliance would be an unrealistic evidentiary burden, an alternative way to demonstrate the causal connection between a defendant’s misrepresentation and her injury.⁴⁰

2. Loss Causation

Once it is recognized that requiring fraud-on-the-market plaintiffs to show transaction causation is inconsistent with *Basic*, it becomes clear that the loss causation requirement makes no sense either. Remember that the loss causation requirement is a follow on to transaction causation. If, to impose liability on a defendant, all that an investor has to show is that she was induced into purchasing shares by the defendant’s misstatement—i.e., transaction causation—the defendant would be insuring the plaintiff against every risk that could possibly depress price below the price paid at time of purchase, including risks totally unrelated to the misstatement. Loss causation is the requirement of “something more,” akin to proximate cause in negligence, that prevents such wide ranging liability.

A loss causation requirement serves no comparable purpose in a fraud-on-the-market action since imposing liability based solely on a showing of this special kind of “reliance” does not lead to similarly wide open results. The “causal connection between a defendant’s misrepresentation and a plaintiff’s injury”⁴¹ is simply different. The plaintiff, rather than saying to the defendant, “you got me into this and now I’ve suffered a loss,” is saying, “I might have purchased anyway even without your misstatement, but your misstatement made me pay more than I otherwise would have.” The claimed loss—that plaintiff paid too much—flows directly from the misstatement. If proved true, the

40. *Id.* at 245.

41. *Basic*, 485 U.S. at 243.

resulting damages paid to the plaintiff compensate the plaintiff for that loss and nothing more. No insurance for any kind of risk would be provided.

C. The Pre-Dura History of the Application of the Transaction Causation/Loss Causation Framework to Fraud-on-the-Market Cases

While the Supreme Court had never discussed the matter prior to *Dura*, the lower courts had consistently said over the preceding twenty years that plaintiffs must show both transaction causation and loss causation in all Rule 10b-5 damage actions, whether based on traditional reliance or on the fraud-on-the-market theory.⁴² Having developed the twin requirement framework for traditional reliance based actions, they apparently felt bound to apply it to fraud-on-the-market actions as well after this new alternative theory of liability became accepted. This effort of the lower courts to cram fraud-on-the-market cases into the ill fitting transaction causation/loss causation framework led to muddy legal reasoning and consequent arbitrary results.

1. Transaction Causation

While the lower courts continue to reiterate the idea that transaction causation means that the defendant's misstatement induced the plaintiff's purchase,⁴³ the success of plaintiffs in pleading and proving transaction causation never seems to be an issue in fraud-on-the-market cases. This is odd given that a substantial portion of the plaintiffs in a typical fraud-on-the-market class action almost certainly would have purchased even if the misstatement had not been made. The courts seem satisfied by the fact that the plaintiffs have shown some sort of "reliance."⁴⁴ This effort at resolution ignores the fact that while traditional reliance and transaction causation are just two names for the same "but for" concept of causation, the *Basic* type of reliance on the integrity of the market price that characterizes fraud-on-the-market cases is not the same as transaction causation.⁴⁵ By glossing over this distinction, the courts make the transaction causation requirement, which logically should not be there at all in this kind of case, trivially easy

42. See *Suez Equity Investors v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001) ("It is settled that causation under federal securities laws is two-pronged: . . . both transaction causation . . . and loss causation"). As discussed in *supra* Part I, the origins of these twin requirements go back to *Globus v. Law Research Service, Inc.* in 1969 and *Schlick v. Penn-Dixie Cement Corp.* in 1975. By 1981, there was in *Huddleston v. Herman & MacLean* a clear appellate court ruling that a showing of both elements was required. For a survey of the cases requiring loss causation, see KAUFMAN, *supra* note 30.

43. See, e.g., *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1147 (11th Cir. 1997); *Bryant v. Apple South, Inc.*, 25 F. Supp. 2d 1372, 1382 (M.D. Ga. 1998); *In re Valujet, Inc., Sec. Litig.*, 984 F. Supp. 1472, 1480 (N.D. Ga. 1997).

44. See, e.g., *Semerenko v. Cendant Corp.*, 223 F.3d 165, 178-83 (3d Cir. 2000).

45. Some courts in fraud-on-the-market cases include as part of the required showing of loss causation a component that sounds more like transaction causation, that is, that the plaintiff must plead and prove that if he had known the truth, he would not have purchased. See *Bryant*, 25 F. Supp. 2d at 1382; *In re Valujet, Inc.*, 984 F. Supp. at 1480. Based on pleadings to this effect, the courts in these cases denied motions to dismiss the complaints. Such a pleading really fails to address whether the plaintiff would have purchased the shares but for the misstatement, however. Nor is it very believable in most cases arising out of purchases in an efficient secondary market. If the plaintiffs, who were outside investors, had known the truth, so would the market. The shares might therefore have been an equally attractive purchase since the market price would have been commensurately lower, compensating for the less rosy, true situation.

to meet. This tactic is innocent enough by itself. After all, as we have seen, if they seriously tried to apply the requirement, they would essentially be reversing the Supreme Court's decision in *Basic*, since the whole point of the fraud-on-the-market action is to allow suits to be brought by plaintiffs who cannot show that the defendant's misstatement caused their purchases. The tactic has had an unfortunate side effect, however. By allowing courts to avoid the reality that no real transaction causation exists, it creates much confusion as to what the standard for loss causation should be.

2. Decisions Finding that Price Inflation Constitutes Loss Causation

Recall the meaning of loss causation, as it was originally developed in the case law: a showing by the plaintiff that the purchased security declined in value from what was paid or was sold at a loss and that the decline or loss is in some way reasonably related to the falsity of the statement that induced the purchase. Some courts prior to *Dura* concluded that a showing that the price at the time of purchase was inflated by the misstatement is sufficient to constitute loss causation. Typically they simply asserted this to be the case and made no attempt to explain how their conclusion relates to the meaning of loss causation as it was originally developed in the case law.⁴⁶

The approach of these courts that a showing of price inflation satisfies the requirement of loss causation had at least two defects in terms of legal reasoning. First, while the courts acquiesced to the idea developed in the prior case law that the plaintiff must make a certain showing, i.e., "loss causation," they provided no reasoning as to how the new meaning that the court assigned to the term related to the meaning developed in the prior case law that established the requirement. Nor do they try to establish how, in the different context of fraud-on-the-market suits, showing price inflation satisfies the purposes for which the original loss causation requirement was developed. Second, the approach redefines loss causation in such a way that the same evidence that these courts found satisfied the transaction causation requirement—that the misstatement caused an inflation in the price the plaintiff paid at the time of purchase—satisfies loss causation as well. Thus, their new definition rendered loss causation, which is supposed to be an additional requirement beyond transaction causation, totally redundant.

Although these courts did not do so, one could argue that allowing a showing of price inflation to satisfy the loss causation requirement in fraud-on-the-market cases sensibly relates to the traditional loss causation formulation because, if a false statement inflates price at the time of purchase, the market, through one route or another, ultimately will reflect the true situation. After that point, the price will be lower than it would have been if the market had never realized the true situation. This argument has defects of its own, however. First, it in essence simply redefines in *ex post* terms the *ex ante* reality that the plaintiff paid more for the security than she would have but for the wrongful misstatement. The *ex post* fact that the price is lower than it would have been if the market had never realized the true situation hardly by itself seems like a compelling reason for compensation. The reason for compensation, if there is one, comes from the *ex*

46. This is the approach of the two leading appellate opinions that hold that in a fraud-on-the-market case, a showing of price inflation satisfies loss causation. See *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003). This is also the approach that was used in the Ninth Circuit opinion in *Dura*, 339 F.2d at 937-38.

ante reality that the plaintiff was forced to pay too much. Second, when the market realizes the true situation, the price will not necessarily be lower than the price the plaintiff paid because, between the time of purchase and the point of market realization, other factors unrelated to the misstatements may have pushed price up by more than the removal of the misstatements' price inflation pushed it down. Therefore, even if the misstatement inflated the price paid, the plaintiff may not have suffered a loss ex post, as required by the traditional loss causation formulation. Third, if all the plaintiff has to show to satisfy the loss causation requirement is that the misstatement inflated price at the time of purchase, she does not need to show, as the traditional loss causation formulation requires, that she held until the point that the market realized the true situation. If she sold earlier than that point, she may have recouped at sale the amount of overpayment at purchase.

3. Pre-Dura Decisions Finding a Showing of Price Inflation Insufficient to Satisfy the Loss Causation Requirement

Other courts concluded that a showing that the price at the time of purchase was inflated by the misstatement is insufficient to constitute loss causation and appeared to require the same showing in fraud-on-the-market cases as in traditional reliance cases. *Robbins v. Koger Properties, Inc.*⁴⁷ and *Semerenko v. Cendant*⁴⁸ are the two leading recent appellate court opinions taking this position. The reasoning in each also has serious problems.

In *Robbins*, the Eleventh Circuit rejected the price inflation theory by the following route. First, it stated that transaction causation is equivalent to reliance and is "akin to actual or 'but for' causation."⁴⁹ Second, it says that the Supreme Court, in articulating the fraud-on-the-market theory in *Basic*, found that a showing of price inflation "creates a presumption of reliance," which, the *Robbins* court says, is "more closely related to... transaction causation," and "not a presumption of causation."⁵⁰ Therefore, the court refused to use the fraud-on-the-market theory to alter the loss causation requirement and stated that it would continue to "require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value."⁵¹

As discussed above, the reasoning in the *Robbins* opinion ignores the fact the kind of reliance established by the Supreme Court in *Basic* is not "but for" causation and hence a showing that satisfies the fraud-on-the-market kind of reliance is not a showing of transaction causation.⁵² The reasoning ignores as well that in *Basic* the Supreme Court describes a showing of price inflation as providing the plaintiff an alternative way to demonstrate "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury,"⁵³ thereby suggesting that the Court *did* regard a showing of price inflation as creating a presumption of causation. The reasoning also ignores the fact

47. *Robbins v. Koger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997).

48. *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000).

49. *Robbins*, 116 F.3d at 1147.

50. *Id.* at 1148.

51. *Id.*

52. See *supra* Part III.B.1.

53. *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

that because the fraud-on-the-market reliance standard is not “but for” causation, there is no need for a showing of something more in the form of traditional loss causation to save defendants from insuring risks unrelated to the subject matter of the misrepresentation. Finally, the reasoning in *Robbins* ignores the special situations existing in the traditional reliance based cases, where the loss causation requirement was developed, that justified the unusual focus on ex post rather than ex ante injury, i.e., that these cases typically arose out of face-to-face or thin or initial market situations where the purchase price the plaintiff paid is not determined in, or guided by, a price in an established, efficient secondary trading market.

In *Semerenko*, the Third Circuit also rejected the inflation theory, stating that “an investor must also establish that the alleged misrepresentation proximately caused the decline in the security’s value to satisfy the element of loss causation.”⁵⁴ It did so on a more policy oriented basis, however. The *Semerenko* court’s concern was that “[w]here the value of the security does not actually decline as a result of an alleged misrepresentation . . . 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.”⁵⁵ The court was certainly right that a plaintiff who sells before full market realization of the truth should have his damages reduced or eliminated by the extent to which the price continues to be inflated by the misstatement. But full elimination of this price inflation, and hence of the Third Circuit’s worry, does not require that the price at time of plaintiff’s sale be below the price he paid, as is required under the traditional loss causation formulation. Again, other unrelated factors may have increased share price by more than the full deflation reduced it. Moreover, as more fully discussed below, the problem of sales prior to partial or full deflation could be considered in terms of the determination of individual damages rather than causation and thus is not necessarily fatal to the use of the inflation theory of loss causation.⁵⁶

D. The Supreme Court’s Missed Opportunity in *Dura*

Dura presented the Supreme Court with an opportunity to clear up this lower court confusion completely. The Court had not developed the twin requirements of transaction causation and loss causation; indeed it had never even commented on them prior to *Dura*. The Supreme Court was therefore in a particularly free position to end the confusion caused by the lower courts’ misapplication of a framework of their own making and to throw out, for fraud-on-the-market suits, these ill-fitting requirements. The Court could have, in clear language, substituted in their place the simple requirement, consistent with its reasoning in *Basic* and the fundamental logic of the fraud on the market theory, that the plaintiff plead and prove that the defendant’s misstatement inflated the price the plaintiff paid. Because of the defendant’s wrongful misstatement, plaintiff paid an extra

54. *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000).

55. *Id.* The court made this statement to suggest that earlier Third Circuit opinions that appeared to adopt the price inflation theory of loss causation might be wrong. What the Third Circuit rule was at this point was not tested by this case, however, since the court found that the complaint alleged that the stock involved “was ‘buoyed’ by the defendants [sic] alleged misrepresentations, and that it dropped in response to disclosure of the alleged misrepresentations,” *id.* at 186, and so the appellate court would have vacated the district court’s granting of defendants’ motion to dismiss under either approach.

56. See *infra* Part III.D.

amount equal to this inflation for something with no greater fundamental value than if the misstatement had not been made. This overpayment is the injury suffered by the plaintiff and thus the injury upon which the causation analysis should focus (although the plaintiff's recovery in damages would be limited to the extent that she receives at the time of sale a benefit arising from the same wrong because of any continuing inflation).⁵⁷

Abandoning the rhetorical confusion of the transaction causation/loss causation framework and instead straightforwardly addressing the underlying reality in the way suggested here would have done more than just clear up confusion. It would have brought the analysis of causation in fraud-on-the-market cases in line with the modern economic thinking that has been the driving force behind the evolution of securities regulation over the last two decades. This thinking has an *ex ante* focus and is concerned with the law's effects on the structure of incentives of the various actors involved at the time the plaintiff enters into the transaction. The *ex ante* focus calls for use of the "out of pocket" measure of damages, i.e., the extra amount the plaintiff pays at time of purchase because of the misstatement (assuming full market realization of the true situation prior to the sale). As we have seen, unlike actions based on traditional reliance, there are no strong reasons in the case of fraud-on-the market actions to depart from this measure.⁵⁸ The "out of pocket" measure has in fact all along been the standard measure of damages in Rule 10b-5 cases generally.⁵⁹

In this regard, it is worth noting that straightforwardly addressing the underlying reality in the way suggested here corresponds to the well known 1982 article by Daniel Fischel, in which he argues, using modern finance theory, that in cases involving actively traded securities, proof of materiality, causation and measure of damages should all go to the same issue: the amount by which the misstatement inflated share price.⁶⁰ While the Supreme Court cited Fischel's article in *Basic*,⁶¹ the lower courts have largely ignored its implications as they have fashioned a post-*Basic* theory of causation for fraud-on-the-market cases. As discussed below, the Court in its *Dura* opinion failed to seize this opportunity to end the confusion created by the lower courts. It retained the transaction causation/loss causation framework and rhetorically treated the case of the plaintiff who sells prior to the market beginning to realize the true situation as one involving an absence of loss causation rather than an absence of damages. Despite its rhetorical shortcomings, however, the Court's opinion leaves open ample room for the development of rules with substantive results that make good policy sense. It is simply important that courts keep the underlying reality in mind as a guide in future action.

III. THE SUPREME COURT'S HOLDING IN *DURA*

Dura involved a class action by plaintiffs who were open market purchasers of defendant *Dura* Pharmaceutical shares. They alleged that they had been damaged as a

57. The reasoning for limiting recovery in this fashion corresponds to Judge Sneed's concurring opinion in *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1341-46 (9th Cir. 1976).

58. See *supra* Part II.B.

59. See *supra* note 35 and accompanying text.

60. See Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 12-13 (1982).

61. *Basic, Inc. v. Levinson*, 485 U.S. 224, 246 n.24 (1988).

result of Dura falsely claiming progress on an asthma medication delivery device that the FDA ultimately found not approvable. The alleged misstatements were made in a series of press releases issued from April 15, 1997, through January, 1998. On February 24, 1998, Dura publicly announced that it expected lower-than-forecast earnings, which it attributed to slow sales of one of its current products, Ceclor CD. Dura's share price dropped sharply, a fact the plaintiffs alleged. In November, 1998, Dura publicly announced the FDA finding that the asthma medication device was not approvable. The plaintiffs did not allege that the November announcement was followed by a price drop, although in fact it was.⁶² The class consisted of all purchasers of Dura Pharmaceutical shares between April 15, 1997, when the firm reported strong progress selling Ceclor CD as well as the completion of "patient dosing" (a step in the tests needed as part of the FDA approval process for the asthma medication delivery device) and February 24, 1998, the date of the lower-than-forecast earnings announcement.

The district court dismissed the complaint in *Dura* for failure to state a claim, deciding that because the complaint did not allege any relationship between the negative FDA finding and the February price drop, the plaintiff failed to plead "loss causation."⁶³ The Ninth Circuit reversed, requiring only a "pleading that the price at the time of purchase was overstated and sufficient indication of the cause."⁶⁴ The Supreme Court granted certiorari on whether, contrary to the Ninth Circuit's position, a plaintiff in a fraud-on-the-market suit such as *Dura* must demonstrate loss causation by pleading and proving a causal connection between the misstatement and a subsequent decline in price.⁶⁵ Defendants, in support of their position that such a demonstration was required, cited opinions from other circuits.⁶⁶ They were joined in their certiorari petition by an amicus brief from the Solicitor General and the Securities and Exchange Commission.

The Supreme Court reversed the Ninth Circuit's judgment. The Court held that a plaintiff cannot establish causation simply by alleging, and subsequently establishing, that the price of the security on the date of purchase was inflated because of a misstatement made by the issuer.⁶⁷ Since the complaint only alleged that the asthma delivery device misrepresentations resulted in the plaintiffs paying artificially inflated prices for Dura securities and that they suffered damages, the Court concluded that the complaint was legally insufficient and remanded the case.⁶⁸

IV. ISSUES REMAINING OPEN

The Court's holding in *Dura* is extremely narrow. It settles only one issue: We now know that a plaintiff who merely alleges, and subsequently establishes, that a positive,

62. The price in fact fell 21%, from \$12 3/8 to \$9 3/4. Brief for the United States as Amicus Curiae Supporting Petitioners, *Dura Pharms., Inc., et al. v. Michael Broudo, et al.*, 125 S. Ct. 1627 (2005) (No. 03-932), 2004 WL 1205204.

63. *In re Dura Pharms., Inc., Secs. Litig.*, No. 99-CV-0151-L (NLLS), 2000 U.S. Dist. LEXIS 15258 (S.D. Cal., Nov. 2, 2001).

64. *Broudo v. Dura Pharms., Inc.*, 339 F.3d 933, 938 (9th Cir. 2003), *rev'd*, 125 S. Ct. 1627 (2005).

65. 124 S. Ct. 2904 (2004).

66. *See, e.g.*, *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997).

67. *Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627, 1629 (2005).

68. *Id.* at 1634-35.

materially false misstatement in violation of Rule 10b-5 inflated the price she paid for a security has not done enough to establish causation in a fraud-on-the-market action for damages. The pleadings must provide, in addition, some indication of the loss and the causal connection the plaintiff has in mind.⁶⁹ And proof at trial must provide evidence that the inflated purchase price proximately caused an economic loss.⁷⁰ The Court, however, does not specify what kinds of allegations and proofs would be sufficient to meet these standards. Specifically, there are two large open questions. One concerns what constitutes a “loss,” specifically whether a plaintiff would ever be allowed to establish that a misstatement caused a loss in a situation where the price at the time suit is brought (or, if earlier, the time of sale) is higher than the purchase price. Stated in more general terms, this first large open question is whether a plaintiff’s loss (and hence damages) is limited to his “actual loss,” i.e., the difference between his purchase price and price at time of sale. The second large open question concerns what, for purposes of pleading, would, beyond the allegation that the misstatement inflated the purchase price, constitute a sufficient “indication of the loss and the causal connection” and what, for purposes of proof at trial, would constitute the kind of evidence sufficient to establish that there had been an inflation in price that proximately caused an economic loss. In particular, is it necessary for the plaintiff to plead and prove a price drop immediately following the public announcement of the truth? Or can the pleadings or proof at trial consist of some other kind of indication that the purchase price had been inflated by the misstatement and that the market had later realized the true situation dissipating this inflation?

A. Sale Price Above Purchase Price

Consider the situation where the price at the time of sale (or, if earlier, the time suit is brought) is higher than the price at the time of purchase, but not as high as it would have been had not a misstatement-caused inflation in price dissipated in the interim. In other words, other news in the interim that was relevant to the issuer’s future but unrelated to the subject matter of the misstatement was, on balance, sufficiently positive that it pushed the price up more than it had been pushed down by the dissipation of the inflation.

In one sense of the word, the plaintiff has suffered no loss. She sold, or at time of suit would have been able to sell, the share for more than she paid for it. In such a situation, application of the loss causation rule developed in the context of a traditional reliance-based action would bar recovery. This rule required that the purchased security decline in value from what was paid (or was sold at a loss) and that the decline or loss is in some way reasonably related to the falsity of the statement that induced the purchase.⁷¹ This position also appears to be urged upon the Court by the defendants in *Dura*, even though *Dura* was a fraud-on-the-market suit, not a traditional reliance-based suit.⁷²

69. *Id.* at 1634.

70. *Id.* at 1633.

71. See, e.g., *Emergent Capital Inv. Mgmt. v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003). The loss causation rule in traditional reliance-based actions and a rationale for its *ex post* perspective for assessing whether a loss has occurred is discussed in Part II *supra*.

72. The question that the defendants successfully sought to have the Court certify was whether a plaintiff

In another sense of the word, however, the plaintiff *has* suffered a loss. Assuming that she does not sell before full market realization of the true situation, the defendant's misstatement has made her worse off in an amount equal to its inflation of purchase price. But for the misstatement, she would have paid exactly that much less for the share, yet her return over her period of ownership (however long, and from whatever mix of dividends, distributions and sales proceeds that she receives) would have been just as great.⁷³ Interestingly, the U.S. government, while arguing in its amicus briefs in *Dura* that the Ninth Circuit ruling in *Dura* should be reversed, took the position that the plaintiff in the situation being considered here has suffered a loss.⁷⁴

The Supreme Court explicitly reserved decision on this matter. It did so by first noting that when a share purchaser who claims that his purchase price has been inflated by a misrepresentation later sells at a price below his purchase price, the lower price may be the result of factors unrelated to the misrepresentation, rather than from the dissipation of an inflated price. The Court then went on to observe that unrelated factors can also push the sale price above the purchase price, stating: "[t]he same is true in respect to a claim that a share's higher price is lower than it would otherwise have been—a claim we do not consider here."⁷⁵

B. Sufficient Pleadings and Proofs at Trial That the Misstatement Caused a Loss

What constitute sufficient pleadings, and proofs at trial, that defendant's misstatement inflated the purchase price in a way that resulted in a loss to the plaintiff? To see the matters left open by the Court in this regard and the variety of considerations relevant to the task of future courts in shaping definitive rules with regard to these open matters, it is helpful to consider four different situations. In each, a plaintiff purchaser in a fraud-on-the-market action claims that she was injured by a defendant issuer's misstatement. At some point after the purchase, there is an unambiguous public announcement by the issuer that the misstatement was false. For simplicity, assume that suit is brought immediately after the announcement (as soon as the market has had a

in a fraud-on-the-market suit must demonstrate loss causation by pleading and proving a causal connection between the misstatement and a subsequent decline in price. Petition for Writ of Certiorari, *Dura Pharms., Inc. v. Broudo*, No. 03-932, 2003 WL 23146437 (Dec. 24, 2003). See also John C. Coffee, *Loss Causation After 'Dura': Something for Everybody*, N.Y.L.J. 5 (May 20, 2005), available at <http://www.law.com/nyl>.

73. This statement is somewhat of an over-simplification since it assumes that the misstatement does not enable management to operate the firm in a different way. It is quite possible that the misstatement allows managers more slack and so they run the firm less profitably, or permits managers to obtain more compensation, both actions that would reduce future returns to the plaintiff. Or the misstatement could allow the firm to obtain financing on more favorable terms, thus possibly increasing the value of the firm. Each of these possibilities, however, raises issues of corporate and securities law that differ from the cause of action under study here.

74. In their briefs, the government makes statements such as "the inflation attributable to the untruth . . . could also be removed through an increase in the price that is smaller than it otherwise would have been," Brief for the United States as Amicus Curiae Supporting Petitioners at 7, *Dura Pharms., Inc. v. Broudo*, No. 03-932, 2004 WL 2069564 (Sept. 13, 2004) [hereinafter Amicus Brief for the United States], and "a decline in price may not be a necessary condition for loss causation, however, because the inflation attributable to fraud could be reduced or eliminated even if there were a net increase in price," Amicus Brief for the United States at 13, *Dura Pharms., Inc. v. Broudo*, No. 03-932, 2004 WL 1205204 [hereinafter Cert. Pet. Amicus Brief for the United States].

75. *Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627, 1632 (2005).

chance to reflect any reaction to the announcement of the truth).⁷⁶ Two other assumptions will be made in this initial discussion of the four situations, which will be dropped in subsequent discussion. One initial assumption is that the plaintiff purchases her shares immediately after the misstatement (as soon as the market has had a chance to reflect any reaction to the original misstatement). The other, to avoid confusion with the other large open question discussed just above, is that in each of the four situations, the purchase price is greater than the share price at the time the suit is brought (and, if the plaintiff sold before the suit was brought, the price at the time of sale as well).

Ultimately, when the discussion of the remaining open issues in this Part III is complete, the implications of four potentially critical variables and their interactions will have been considered: was there a significant price drop after the unambiguous public announcement of the falsity of the misstatement or not; did the plaintiff continue to hold her shares until after this public announcement of the truth or did she sell earlier; did the plaintiff purchase the shares immediately after the misstatement was made or later; and was the sale price lower or higher than the purchase price. The implications of the fact that most fraud-on-the-market actions are class actions will also be considered.

1. The First Situation: Price Drops Immediately After the Public Announcement of the Truth While Plaintiff Still Holds Shares

In the first situation, the plaintiff still holds the shares at the time suit is brought. She alleges, and proves at trial, that immediately after the announcement of the falsity of the misrepresentation, the price dropped significantly.

There is little doubt that this plaintiff satisfies the Court's requirements under *Dura* concerning causation. The drop in price after the announcement strongly indicates that the misstatement, when made, inflated price. It would simultaneously indicate, consistent with the efficient market hypothesis, that after the announcement, the market realized the true situation, thereby dissipating the inflation in price. The misstatement caused the plaintiff to pay more than she would have otherwise and, because she held her shares until the inflation had dissipated, she did not recoup her injury through a sale at a similarly inflated price. Thus she suffered a loss as a result of the misstatement.⁷⁷ Given these considerations, the plaintiff's allegation of the price drop immediately after the announcement of the falsity of the misstatement would certainly satisfy the Court's requirement that the plaintiff allege "some indication of the loss and causal connection." Proof of this price drop at trial would be a strong indication both that the misrepresentation inflated the purchase price and that the inflation later dissipated before the plaintiff sold, thereby proximately causing a loss.⁷⁸

76. This assumption is made for expositional convenience to avoid needing to describe separately the state of affairs where the plaintiff sells after the public announcement but before the suit is brought from the state of affairs where the plaintiff still holds the shares at the time suit is brought. Any differences in the results between these two states of affairs is not important for points I am making in this discussion.

77. I assume throughout this Article that the impact on the underlying fundamental value of the issuer's shares of the facts asserted by the misstatement, if these facts were true, would remain constant. *See infra* Part VI.C for further discussion of this assumption.

78. Modern corporate finance teaches us that calculations of price drops or increases of this sort should, when possible, be done on an adjusted basis using the market model to take account of the influence of other factors that are simultaneously moving share prices in the market generally. RONALD J. GILSON & BERNARD S.

What, though, about cases where, unlike this first situation, there is no share price drop immediately following the announcement. Is there any other kind of evidence that satisfies the Court's loss causation requirements and, if so, under what circumstances? Some of the circuit court opinions cited by the defendants in *Dura* appear to suggest that nothing else would do,⁷⁹ but, as is elaborated just below in the discussion of the second and third situations, there are respectable arguments for allowing submission of a broader range of evidence on the matter and the Court has left this question open.

2. The Second Situation: Price Does Not Drop Immediately After the Public Announcement of the Truth While Plaintiff Still Holds Shares

In this second situation, unlike the first, there is no significant price drop immediately after the announcement of the falsity of the misstatement. Since we assume that suit is brought right after the announcement and that the price after the announcement is lower than at the time of purchase, there has been a price drop at some point, just earlier than the announcement. Like in the first situation, the plaintiff still holds the shares at the time suit is brought.

In this second situation, the plaintiff should again easily be able to allege and prove that the market realized the true situation. This is because the issuer made an unambiguous public announcement that the earlier misstatement was false. The efficient market hypothesis tells us, therefore, that to the extent, if any, the misstatement inflated the purchase price in the first place, the price after the public announcement was no longer inflated by the misstatement. Thus, to the extent the misstatement caused the plaintiff to pay more than she otherwise would have, she did not recoup her injury through a sale at a similarly inflated price. As a consequence, if the misstatement did inflate the purchase price, it caused the plaintiff to suffer a loss.

Did the misstatement in fact inflate the purchase price, however? The fact that there was no negative price reaction after the unambiguous announcement is unhelpful to the plaintiff's claim, but it does not rule out the possibility that the misstatement inflated the

BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 194-95 (2d ed. 1995). While the courts and securities litigants increasingly recognize that price drops and increases should be calculated in this fashion, the practice is far from universal. All of the inferences in the Article that I suggest can be derived from price drops or increases are stronger when they are calculated on a market adjusted basis. Where the plaintiff submits only an unadjusted price change as evidence supporting his claim that the misstatement inflated his purchase price, it is appropriate for the defendant to be able to introduce market adjusted data. If the defendant's data convincingly show that there has been no price change on a market adjusted basis, the inferences suggested here that can be drawn from an adjusted price change would be unwarranted. Where the plaintiff does submit to a market adjusted price change as evidence supporting his claim that the misstatement inflated his purchase price, it is also appropriate that the defendant be allowed to introduce any evidence that some other firm-specific event occurred simultaneously that can explain the price movement. The inferences in this Article that I suggest can be derived from price drops or increases assume that the defendant presents no persuasive evidence of this kind. If in fact the defendant does introduce persuasive evidence that some other firm-specific event unrelated to the misstatement or its correction explains the price change, then again the inferences suggested here would be unwarranted.

79. *Semerenco v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1148 (11th Cir. 1997). Each of these cases calls for pleading and proving that there was a causal connection between the misstatement and a subsequent decline in price. It is not clear whether these courts maintain that to establish the causal connection, the decline in price needs to be subsequent to the public announcement of the truth or only subsequent to the original misstatement.

purchase price. This is because the misstatement might initially have inflated the share price but the market may have realized the true situation prior to the public announcement of the truth. Complete market realization of the true situation in this context means that the price is no longer any higher than it would have been if the misstatement had never been made. Prior to an unambiguous public announcement, the operation of one or more phenomena may lead to a complete market realization of the truth. One way is a series of earlier, smaller disclosures by the issuer or others that gradually leads market participants whose actions set price to conclude that the misstatement was false. Another is that the price is pushed back to the level it would have been but for the misstatement as a result of trading by insiders or others based on non-public information or rumors concerning the true state of affairs. Another would be a growing quiet awareness on the part of certain highly sophisticated market participants—arbitrageurs and sell side analysts—that previously publicly-available facts, which for a time had gone unnoticed or seemed unimportant, were in fact inconsistent with the misstatements. Yet another is that the higher earnings or sales in the future that one would have predicted based on the misstatement do not materialize or the poor financial condition of the issuer, which the misstatement masked, subsequently becomes obvious.

In *Dura*, the Court's requirements concerning how a plaintiff establishes that a misstatement caused a loss are phrased in terms of what more, beyond an inflation in the purchase price, needs to be pled and proved. The Supreme Court's decision to phrase its requirements in these terms was presumably due to the way, in turn, that the Ninth Circuit opinion in *Dura* phrased its holding. Unfortunately, phrasing its requirements in these terms is likely to lead to new confusion. In the very common situation where the plaintiff still holds the shares after the public announcement of the falsity of the misstatement, the "something more" is the public announcement. As just discussed, where the plaintiff already has clearly established that the misstatement inflated the purchase price, the public announcement is surely enough additional evidence to establish that the plaintiff suffered a loss. Indeed, the only coherent story that the Court tells as to how an inflated purchase price might not lead to a loss is where the investor resells at the still inflated price.⁸⁰ The efficient market hypothesis rules out any continuing inflation in price once there has been an unambiguous public announcement of the falsity of the misstatement.

There is thus an irony in the Court's phrasing of its loss causation requirements in terms of what more needs to be established beyond the inflation in purchase price. For a plaintiff who still holds shares at the time of the public announcement, if anything is going to be difficult to establish, it is that the purchase price was inflated, not the "something more." I suspect that in cases such as this second situation, where there is no significant share price drop immediately following the public announcement, the issue of whether the misstatement inflated the purchase price is in fact the one troubling the Court as well. The Court is probably concerned that in many of these cases, there was in fact no inflation in the first place and hence no possibility that misstatement caused a loss. The misstatement, although arguably facially material, did not inflate the purchase price and unrelated factors caused the share price drop observed prior to the public

80. See *infra* Part IV.B.

announcement.⁸¹

In some cases resembling this second situation, therefore, the misstatement did inflate the purchase price and hence certainly did cause the plaintiff a loss, and in others it did not inflate the purchase price and hence could not possibly have caused a loss. The existence of both these possibilities gives rise to a question that will have to be addressed by future courts: Where there is no significant price drop after the public announcement of the falsity of the misstatement, what alternative kinds of evidence, if any, will the plaintiff be allowed to introduce to establish that the misstatement inflated the purchase price?

The strongest alternative evidence would be a showing that the misstatement itself, when initially made, was immediately followed by a significant price increase. This kind of evidence should be at least as acceptable as a significant price drop at the time of the public announcement of the falsity of the misstatement because it is at least as good a market confirmation of the importance of the misstatement. The problem, however, is that of all the misstatements that do in fact inflate the purchase prices of issuers' shares, probably most are made to avoid disappointing expectations rather than to increase expectations, which means they are not followed by an immediate significant price increase.

Thus, it is important whether other, less definitive kinds of evidence of purchase price inflation are also acceptable. If less definitive evidence is allowed, it would need to relate to a combination of showings. First, the plaintiff would need to establish that the misstatement was self-evidently important in the sense that if it were considered reliable, it would significantly affect investors' expectations concerning the issuer's future returns. The importance of the statement in this sense is something that could be established, for example, by testimony of analysts or industry experts. Such testimony would tend to be more persuasive if it was empirically supported by studies showing the effect of similar announcements on the share prices of other firms. Second, the plaintiff would need to establish that the misstatement was in fact believed by the participants in the market whose actions set prices. One indication of the extent to which it was believed would be the reactions of analysts or the financial media at the time the misstatement was made. Finally, the plaintiff would have to explain how a claim that the misstatement inflated the purchase price could be consistent with the absence of a price decline immediately after the later public announcement of its falsity. Such an explanation would presumably require the testimony of financial economists or securities market professionals able to point to grounds for believing that, by one or more of the other routes discussed above, the market was realizing the true situation prior to the public announcement. The more persuasive the first two showings—the self-evident importance of the misstatement and its acceptance as true by the market—the less complete this third showing—the explanation of how the market realized the true situation prior to the public announcement—needs to be for the overall case to be convincing.

Nothing in the Court's holding in *Dura* rules out use of these other less definitive kinds of evidence. Since market realization of the true situation by routes other than a public announcement is not uncommon, allowing submission of these other kinds of evidence will permit actions to succeed in the many cases where the purchase price

81. See *infra* Part IV.B.

genuinely was inflated but where there was no negative price reaction immediately after the announcement. On the other hand, because these other kinds of evidence are less reliable than a price drop immediately after the announcement or a price increase immediately after the misstatement, allowing them will also permit more actions to succeed where in fact the misstatement did not inflate the purchase price.

Of all the kinds of cases where a plaintiff might claim market realization of the true situation by other routes prior to an unambiguous public announcement of the falsity of the misstatement, the easiest to show are the ones involving allegations that the price dropped after the higher earnings or sales in the future that one would have predicted based on the misstatement did not materialize or after the poor financial condition of the issuer, which the misstatement masked, subsequently became obvious. Indeed, how to deal with these kinds of allegations has been a central question in many of the lower court fraud-on-the-market causation cases decided since the Supreme Court's decision in *Dura*.

In some of these cases, the courts refuse to accept such allegations as satisfying the loss causation requirement under circumstances suggesting that they might, as a general matter, always insist on an allegation of price drop after the misrepresentation itself has been unambiguously identified and corrected.⁸² If this interpretation is correct, the implicit rule seems harsh since often the announcement of the falsity of the misstatement is the last act in a drama where the true troubled situation had become apparent well before.

Admittedly, the disappointment concerning earnings that leads to a price drop may

82. For example, in an unpublished opinion, the Sixth Circuit affirmed a district court dismissal with prejudice of a complaint alleging that during the first half of 2001, Kmart improperly reported as a reduction in current expenses rebates that it hoped to receive before the end of the year. *D.E. & J. Ltd. P'ship v. Conaway*, 133 F. App'x 994, 996-97 (6th Cir. 2005). The complaint alleged a sharp drop in share price in later 2001 after it reported flat sales in September and declining sales in November and December, a further 60% price drop following Kmart's announcement of filing for bankruptcy on January 22, 2002. The complaint alleged as well that starting on January 25, 2002, there were various announcements suggesting accounting improprieties capped by a restatement of 2001 earnings on May 15, 2002, that included a reversal of the treatment of the hoped for rebates. *Id.* at 996-97, 999-1001. There was no allegation of a drop in price after the May 15, 2002, restatement. *Id.* at 1001. The court found that "D.E. & J.'s causation theory looks remarkably like Broudo's allegations in his complaint [in *Dura*]." *Id.* at 1000. In support of this finding, the court stated "D.E. & J. never alleged that Kmart's bankruptcy announcement disclosed any prior misrepresentations to the market" and that "D.E. & J. has done nothing more than note that a stock price dropped after a bankruptcy announcement, never alleging that the market's acknowledgment of prior misrepresentations caused that drop." *Id.* These statements come close to saying that price drops following disclosures that reveal the true situation are not insufficient to establish loss causation since they do not specifically identify the misstatement itself and announce its falsity. See also *In re Tellium, Inc. Sec. Litig.*, 2005 U.S. Dist. LEXIS 19467 (D.N.J. June 30, 2005); *In re Bus. Objects S.A. Sec. Litig.*, 2005 U.S. Dist. LEXIS 20215 (N.D. Cal. July 27, 2005).

Taking a perhaps more middle ground, the court in *Porter v. Conesco, Inc.*, 2005 Dist. LEXIS 15466 (S.D. Ind. July 14, 2005), granted, without prejudice, defendant's loss causation based motion to dismiss a complaint alleging major accounting irregularities and a drop in price after the company made an announcement revealing that the company was performing poorly but not disclosing the existence of the irregularities. The court says "[t]his is not a case where plaintiffs can point to a sharp drop in the company's stock price following announcement of the allegedly concealed truth. The stock had long since hit bottom before these alleged misrepresentations . . ." *Id.* at 12. The court noted that plaintiffs claimed in argument that the truth was beginning to "leak out" and thus contributing to the slide in share prices. The court responded that "whether the [*Dura*] Court's use of the phrase 'leak out' shows that plaintiffs' suggestion would be sufficient under *Dura Pharmaceuticals* is not clear. It is clear, however, that this theory is certainly not what plaintiffs have alleged in the operative complaint." *Id.* at 13.

only be at most in part due to an earlier misstatement. Similarly, the revelation of poor financial condition leading to a price drop may only at most have been partly hidden by an earlier misstatement. Thus, in each case, the price drop that follows these events does not show that the misstatement in fact inflated price in the first place with the same clarity as would a price drop that follows an unambiguous public announcement of the falsity of the misstatement. This problem is particularly difficult where an issuer's share price has dropped substantially and it is obvious that at least some significant portion of decline in the market's evaluation is due to factors unrelated to the misstatement.

On the other hand, sometimes the relationship between original misstatement and at least a portion of the subsequent disappointment or revelation is fairly clear, for example, where premature earnings recognition in violation of GAAP is followed within a few quarters by an earnings disappointment of a similar magnitude. A dollar more in the earlier period obtained through premature recognition is bound to mean a dollar less in some subsequent period. If the market does not understand that income in the earlier period has come from this tradeoff, falsely optimistic expectations about future earnings are bound to develop and bound to be ultimately disappointed. In apparent recognition of the existence of such circumstances and the resulting harshness of an absolute bar, other courts have denied loss causation based defendant motions to dismiss or for summary judgment where the plaintiffs have alleged that the price dropped when the higher earnings or sales in the future that one would have predicted based on the misstatement did not materialize or when the poor financial condition of the issuer, which the misstatement masked, subsequently became obvious.⁸³

3. *The Third Situation: Price Does Not Drop Immediately After Public Announcement of the Truth and Plaintiff Has Sold Shares Earlier*

In this third situation, like in the second, there is a price drop prior to the announcement of the falsity of the misstatement but there is no significant price drop immediately after the announcement. Unlike in the second situation, however, the plaintiff sells before the announcement. In this third situation, to prove that the misstatement caused a loss, the plaintiff must both show that the misstatement inflated the purchase price and that his sale occurred after at least partial market realization of the

83. See, e.g., *In re Daou Sys., Inc. Sec. Litig.*, 411 F.3d 1006 (9th Cir. 2005) (reversing a district court grant of a defendant's loss causation based motion to dismiss a complaint alleging accounting violations involving premature recognition of income and a stock price drop after a later announcement that disclosed disappointing earnings but not the fact that they were the result of prematurely recognized income in earlier periods); *In re Immune Response Sec. Litig.*, 375 F. Supp. 2d 983 (S.D. Cal. 2005) (denying a defendant's loss causation based motion to dismiss a complaint alleging misstatements that predicted likely FDA approval of an anti-HIV drug and asserted certain favorable test results and alleging a price drop after publication of an academic paper contested by the issuer that cast doubt on the test results and a further price drop after a financial co-venturer pulled out); *In re The Loewen Group, Inc. Sec. Litig.*, 2005 U.S. Dist. LEXIS 23841 (E.D. Pa. Oct. 18, 2005) (denying a defendant's loss causation based motion for summary judgment with regard to a suit in which plaintiffs provided evidence that the issuer overstated income by failing, when booking zero interest installment sales, to discount to present value the future installments and that share prices dropped after the company's announcement of \$80 million charges for "reserves and other adjustments" that did not reveal that a portion of the charge was to account for the previously disregarded imputed interest, but in which plaintiffs produced no evidence that the share price dropped after a later disclosure of the accounting irregularity itself).

true situation. To establish that the misstatement inflated price, the plaintiff would need to make the same showings with regard to the self-evident importance of the misstatement and its acceptance by the market as true as would the plaintiff in the second situation. The third showing relating to how the market realized the true situation prior to the public announcement of the misstatement's falsity takes on new importance, however. This is because the plaintiff will not only need defensively to explain why the lack of market reaction to the announcement of the falsity of the misstatement does not undermine the plaintiff's other evidence showing the misstatement's importance and acceptance as true, but also must affirmatively show that the partial or full market realization of the true situation occurred prior to his sale of the shares.

This difference is significant. At least where share price continued to fall after the plaintiff's sale, any weakness in the plaintiff's showing that the decline prior to his sale was due to market realization of the true situation cannot, unlike in the second situation, be compensated for by the strength of his showings relating to the misstatement's self-evident importance and acceptance as true. The plaintiff needs to establish that market realization of the true situation occurred prior to his sale to show that he did not recoup his injury through resale at an inflated price. The lack of a significant price drop after the announcement of the falsity of the misstatement despite a strong showing of the self-evident importance of the misstatement and its market acceptance as true may be just as easily explained as the result of a market realization of the true situation after the plaintiff's sale as before. Thus, while again nothing in the Court's *Dura* opinion rules out the acceptability of the kinds of evidence that the plaintiff in this third situation would need to introduce, a presentation of the same evidence by the plaintiff in the third situation would be less reliable as to whether the misstatement really caused the plaintiff economic disadvantage than if the same evidence were introduced by the plaintiff in the second situation. This lower level of reliability provides a rationale for a bright line rule prohibiting a finding of loss causation in cases resembling this third situation but not prohibiting such a finding in cases resembling the second situation. The existence of a rationale does not necessarily mean, however, that such a bright line rule should be adopted. Again, there is the familiar tradeoff involved in adopting such a rule. On the one hand, it prevents the introduction of evidence that is less reliable, and thus it will block actions that otherwise would have succeeded where in fact the misstatement did not cause the plaintiff economic disadvantage. On the other hand, it will also block actions that otherwise would have succeeded where in fact the misstatement did cause the plaintiff economic disadvantage.

4. The Fourth Situation: Price Drops Immediately After the Public Announcement of the Truth But the Plaintiff Sells Earlier

In this situation, like in the first, there is a price drop immediately after the public announcement of the falsity of the misstatement. Unlike in the first situation, but like the third, the plaintiff sells before the announcement. The plaintiff in this situation cannot claim a loss based on the portion of inflation in his purchase price indicated by the price drop at the time of the public announcement. This is because he sold before market realization of this portion of the inflation. Thus, the price he received still reflected it, thereby allowing him to recoup this portion of his injury. To prove that the misstatement caused him any loss, the plaintiff must both show that the misstatement inflated his

purchase price by more than was indicated by the price drop after the public announcement and that his sale was after market realization of the facts relating to this additional inflation.

This plaintiff's proof problems are therefore essentially identical to the plaintiff in the third situation. He cannot use the price drop after the public announcement to establish that his purchase price was inflated in a way that caused him a loss. He needs to show the existence of some additional inflation that is not indicated by a post-announcement price drop and he needs to show that market realization of the true situation with regard to this additional inflation occurred prior to his sale. As a consequence, future courts face the same range of possible rules concerning what evidence to admit with regard to this fourth situation as they do with regard to the third. Whatever set of rules they choose to deal with one situation should be applied to the other as well.

5. Changing the Four Situations to Reflect a Later Purchase

The four situations assume that the plaintiff purchases his or her shares immediately after the misstatement (as soon as the market has had a chance to reflect any reaction). What if the plaintiff purchases after that point, but before the public announcement of the truth? A later purchase may alter the analysis because, to the extent, if any, that the market realized the truth by the time of the purchase, the inflation in the purchase price would be commensurately dissipated, along with the potential loss.

The fact that the purchase was made later should not alter any conclusions with regard to the first situation, where the price drops after the public announcement of the falsity of the misstatement and the plaintiff is still holding her shares. Assuming that the plaintiff is not claiming an inflation in purchase price greater than what is indicated by the price drop after the public announcement, the market clearly had no realization of the true situation until the announcement and therefore not until after the plaintiff's purchase.⁸⁴ Her purchase price would have involved the full amount of the inflation caused by the misstatement. Thus, the analysis made of the first situation as originally portrayed is equally applicable here and the plaintiff should easily be able to meet the Court's requirements in *Dura* concerning pleading and proving loss causation.

In the second situation, where there is no price drop after the public announcement of the truth and the plaintiff is still holding the shares, the plaintiff needs to prove that the misstatement inflated price by a showing that the misstatement was self-evidently important and was accepted by the market as true. He also needs to reconcile the claim of price inflation with the absence of a price drop after announcement through an explanation of how the market realized the true situation prior to the public announcement. It was observed earlier, in the discussion of the second situation as originally portrayed, that the more persuasive the showings of the self-evident importance of the misstatement and its acceptance as true by the market, the less complete the explanation of how the market realized the true situation prior to the public

84. Such a plaintiff, of course, might well claim there was additional inflation that was not reflected in the price drop after the announcement because the market partially realized the true situation prior to the announcement. This portion of the plaintiff's claim is the same as the claim made by the plaintiff in the second situation and should be treated accordingly by the courts.

announcement needs to be for the overall case to be convincing. Where the plaintiff makes her purchase later, however, this explanation of how the market realized the true situation takes on independent importance. This is because the plaintiff, to establish that he suffered a loss, needs to show that the market has not already fully realized the situation when he makes his purchase. This change in the second situation, with the plaintiff purchasing later, consequently converts it to one that in this regard resembles the original portrayal of the third situation, where the plaintiff buys right after the misstatement but sells before the public announcement.⁸⁵

Because of this resemblance, the analysis made in the original portrayal of the third situation is equally applicable to this changed version of the second situation. As a consequence, future courts face the same range of possible rules concerning what evidence to admit with regard to this changed version of the second situation, with the plaintiff purchasing later, as they do with regard to the third situation as originally portrayed. Again, whatever set of rules they choose to deal with one should be applied to the other as well.

The same can be said of changing the third and fourth situations to reflect a later purchase by the plaintiff. Whether the plaintiff purchases immediately after the misstatement (as the situations were originally portrayed) or later, the plaintiff's challenges are the same. She must demonstrate the existence of price inflation without the aid of a price drop after the announcement, and her explanation of how the market realized the true situation takes on importance independent of that demonstration.

6. Class Actions Typically Involve a Mix of These Situations

Most fraud-on-the-market actions are class actions. The typical class is composed of all persons who purchased an issuer's shares from the time of the misstatement to the time of the public announcement of its falsity. Thus, it will contain plaintiffs in several of the situations described above. These realities are something that will inevitably need to be considered by future courts as they fashion rules to deal with these situations. These class actions fall into two categories: ones in which the public announcement is followed by a significant price drop and ones in which it is not.

The analysis of class actions where there is a price drop immediately following the public announcement of the truth is very straightforward. Assuming that there is no claim of inflation in purchase price beyond what is indicated by the price drop after the public announcement, the market clearly had no realization of the true situation until the announcement and therefore not until after the purchases by all of the members of the class.⁸⁶ For any member of the class still holding the shares at the time the suit is

85. In the second situation as originally portrayed, I suggested that an alternative way for the plaintiff to demonstrate that her purchase price had been inflated was to introduce evidence that there was a price increase immediately after the misstatement was made. If the plaintiff could successfully show such a price increase, this would be sufficiently convincing evidence of the misstatement inflating her purchase price that she would not need to provide an explanation of how the market realized the true situation prior to the public announcement. With the second situation changed to reflect the plaintiff purchasing later, however, the plaintiff would need to provide such an explanation, to show that market realization had not occurred before her purchase.

86. Similar to the discussion of individual claims in Part III.A.5 *supra*, there might well be a claim that there was additional inflation that was not reflected in the price drop after the announcement because the market partially realized the true situation prior to the announcement. This portion of the claim is the same as the claim

brought, whenever they were purchased, meeting the Court's requirements in *Dura* concerning pleading and proving loss causation should be easy. For the rest of the members of the class, meeting these requirements should be impossible because they sold prior to the announcement and thus recouped all of the claimed inflation.

The analysis of class actions where the public announcement of the truth is not followed by an immediate significant price decline raises more issues. It is important to stress, however, that for the class as a whole, the proof problems are simpler than in many of the individual claims considered in the situations above. This is because, for every share purchased at least once between the time of the misstatement and the time of the public announcement, one or more members of the class suffer losses that in the aggregate equal the amount, if any, by which the share's price was inflated at the time of its initial purchase. If the share is purchased only once during the class period, the single purchaser suffers this full loss. If the initial purchaser sells it prior to the end of the class period and the price at the time of her sale is still inflated to one extent or another, she will recoup part or all of her injury. But the second buyer of this share, if he holds until the suit is brought, sustains whatever portion of the loss was not sustained by the first buyer. If there are three or more purchases of the share during the class period, the same process is at work. Whatever portion of the loss is not sustained by the earlier purchasers is sustained by the later ones. Fundamentally, for the class as a whole, the situation is akin to the second situation (where the plaintiff still holds her shares at the time of suit) changed, as discussed above, to reflect that some of the shares purchased during the class period were purchased at a point in time later than immediately after the misstatement.

Probably, however, some members of the class would have purchased immediately after the misstatement and others close enough to that date that if there was any inflation caused by the misstatement, its dissipation was unlikely to have already occurred. As far as the class as a whole is concerned, the shares initially purchased by these class members, even if sold by them prior to the announcement, are more akin to the second situation as initially portrayed, where the individual plaintiff purchases immediately after the misstatement is made and still holds her shares at the time the suit is brought. With regard to these shares, one or more members of the class will in aggregate suffer losses equal to the full amount by which the price was initially inflated by the misstatement. Thus, the methods of proving that the class as a whole suffered at least some losses are the same as for the individual claimant in the originally portrayed second situation. One method of proof is to show there was a price increase immediately following the misstatement. If there was no such increase, the other way of showing the class as a whole sustained at least some losses is to establish that the misstatement inflated price by a showing that the misstatement was self-evidently important and was accepted by the market as true and by reconciling the claim of price inflation with the absence of a price drop after announcement through an explanation of how the market realized the true situation prior to the public announcement. Like the second situation as originally portrayed, to prove that the class as a whole suffered at least some damages, the explanation of how the market realized the true situation takes on no independent significance: the more persuasive the showings of the self-evident importance of the

in a class action where the public announcement is not followed by an immediate significant price drop and should be treated accordingly by the courts.

misstatement and its acceptance as true by the market, the less complete the explanation of how the market realized the true situation prior to the public announcement needs to be for the overall case to be convincing. As long as it is established that the misstatement inflated price, for each of the shares initially purchased immediately, or soon after, the misstatement was made, one or more members of the class suffered a loss that in aggregate equals the full amount by which the misstatement initially inflated the share price.

C. Combining the Open Questions

I have discussed the two large questions left open by the Court's opinion in *Dura* separately from each other to make clear what is at stake with each. Under some circumstances, there is a possible interaction between the two, however. Consider each of the four situations described above as initially portrayed, except with the modification that the purchase price is less than, not greater than, the share price at the time the suit is brought (and, if the plaintiff sold before the suit was brought, than the price at the time of sale as well).

1. Revisiting the First Situation

In the first situation, where the announcement of the falsity of the misstatement is immediately followed by a significant stock price drop and the plaintiff still holds the shares at the time suit is brought, this changed assumption that the price at the time of suit is higher than the purchase price turns out to be unimportant. This is because the significant price drop after the announcement is a very strong indication that the misstatement did inflate the purchase price. The fact that the price after the announcement is still higher than the purchase price does very little to undermine this conclusion since the drop after the announcement strongly suggests that the increase before the announcement was due to unrelated factors. Since the plaintiff clearly held the shares until after market realization of the true situation, the misstatement, which inflated her purchase price, unquestionably makes her economically worse off. The case is essentially as strong for providing compensation to the plaintiff in this modified version of the first situation as in the situation as originally portrayed. Unless the ultimate rule turns out to be that under no circumstances can there be compensation without an ex post loss, which in my view would be unfortunate,⁸⁷ the plaintiff in this modified version of the first situation, with the price at the time of suit greater than purchase price, should still meet the Court's pleading and proof requirements under *Dura* concerning causation.

2. Revisiting the Second and Third Situations

In the second and third situations, however, where there is not a significant price drop after the falsity of the misstatement is announced, the fact that the price at time the suit was brought (or, in the third situation, at the time of sale) was higher than the price at time of purchase weakens the plaintiff's claim that the misstatement inflated the price.⁸⁸ In these situations, if the misstatement had in fact inflated the price, the dissipation of the

87. See *infra* Part IV.A.

88. The exception to this statement is where the price rose immediately after the misstatement was made.

inflation would have needed to occur between the time of purchase and the time of the announcement of the falsity of the misstatement (or, in the case of the third situation, the time of sale) and this dissipation would have exerted downward pressure on price. As for the other influences on price during this period, unrelated to the misstatement, there is just as great a probability that they too, on a net basis, would have exerted a downward force on price as an upward one. This means that if there was any inflation to be dissipated, the combination of the dissipation of the inflation and the other unrelated influences on price were more likely to be negative than positive.⁸⁹ Thus, standing alone as a single piece of evidence, the fact that the price at the time of suit or earlier sale is higher than at the time of purchase suggests that it is more likely than not that a misstatement-caused inflation never existed in the first place. Moreover, the greater the increase in price, the more likely this piece of evidence suggests that there was no inflation from the misstatement.

The fact that the price went up does not, of course, rule out the possibility that there was inflation in price due to the misstatement: as discussed earlier, the other unrelated influences on price might well, on a net basis, have been positive and enough to more than counterbalance the downward force exerted on price from dissipation of an inflation due to the misstatement. The increase in price is simply, on a probabilistic basis, a negative piece of evidence to be weighed against whatever positive pieces of evidence the plaintiff might present in her efforts to show the self-evident importance of the misstatement and its acceptance as true by the market and to explain how the market realized the true situation prior to the public announcement of its falsity. Thus, one approach future courts might take is simply to consider all of these positive pieces of evidence offered by the plaintiff and, if they are persuasive enough to overcome the negative inference flowing from the fact that the price went up, find that the plaintiff established that the misstatement inflated price.

Alternatively, the lower courts might construct one of a number of possible simplifying bright line rules triggered by the price at time of suit or earlier sale being higher than the purchase price. The most extreme rule would be, for cases that otherwise resemble the second or third situations, an absolute bar on payment of damages. There exists a rationale for such a bright line rule even if the law develops in a way that permits compensation despite the lack of an *ex post* loss in cases where there is either a significant price drop immediately after the announcement of the truth (i.e., cases resembling the first situation) or where there is a significant price rise immediately after the misstatement. If a case has neither of these characteristics, the plaintiff's argument that the misstatement inflated price will have to rest on her showing of the self-evident importance of the misstatement and its acceptance as true by the market and her explanation how the market realized the true situation prior to the public announcement of its falsity. The justification for a bright line rule banning any such case would be that the plaintiff's argument is inherently weakened by the fact that the price at the time suit is brought is higher than the purchase price.

89. To be more precise, this statement would need to be modified to recognize that these unrelated factors push price up or down from a path that reflects the fact that over the long run share prices on average tend to grow. See *supra* note 9. For relatively short periods of time, such as one or two quarters, however, this growth factor is likely to be small relative to the other factors at work.

A less draconian bright line rule would be an absolute bar on payment of damages only where the increase in price between time of purchase and time suit was brought (or earlier sale) was substantial relative to past fluctuations in price. Another approach would be to bar compensation unless the plaintiff can meet the burden of establishing the existence of unrelated factors that could be expected to increase price by more than he claims the misstatement inflated price.

Again, the usual tradeoff is involved. The more restrictive the rule in terms of what evidence can be introduced, the more cases will be blocked where the misstatement in fact does cause the plaintiff economic disadvantage and the more cases will be blocked where in fact it does not.⁹⁰

3. Revisiting the Fourth Situation

Again, assume the price at the time of sale is greater than the purchase price. Consider, with this modification in assumptions, the fourth situation, where the share price drops significantly immediately after the announcement of the truth but where the plaintiff has sold her shares before that point. As noted in the earlier discussion of this fourth situation, the plaintiff in this situation cannot claim a loss based on the portion of inflation in his purchase price indicated by the price drop at the time of the public announcement.⁹¹ To prove the misstatement caused him any loss, the plaintiff must both show that the misstatement inflated his purchase price by more than was indicated by the price drop after the public announcement and that his sale was after market realization of the facts relating to this additional inflation. The modifying fact that the price at time of sale is greater than the purchase price has the same significance as it does in modifying

90. My colleague Professor John Coffee favors a bar of some sort to recovery where the price at the time suit is brought (or, if earlier, at time of sale) is higher than the purchase price. Coffee, *supra* note 72, at 5. It is unclear, however, whether he favors a blanket bar to all such actions. He may simply favor a bright line rule barring recovery unless there is strong, definitive evidence that the purchase price was inflated in the first place. In other words, he might allow recovery in the first situation, involving a price decrease after the announcement of the truth but to a level still above the purchase price, or where there is a price rise immediately after the original misstatement, but otherwise bar recovery where the price at time of suit (or earlier sale) is higher than the purchase price.

Coffee's reasoning really only supports this latter, narrower bar. His stated concern is with what the absence of an *ex post* loss says about the likelihood that the price was inflated in the first place, not an insistence that an investor must suffer an *ex post* loss for the investor to have been made economically worse off by a misstatement. Coffee says "[e]conomically, there is little conceptual difference between a price decline because of the discovery of a prior misstatement and a price that does not change because positive and negative news have offset each other." *Id.* at 8. He poses the following hypothetical, however. The share price increases by \$5 from time of purchase to time of suit. A plaintiff claims that a misstatement inflated the price by \$10 and that the market realization of the truth has dissipated this inflation but at the same time macroeconomic news has boosted price by \$15. Thus, the \$5 price increase is consistent with the plaintiff's claim that the misstatement made him \$10 worse off. But it is also consistent with the misstatement having caused no inflation in price and macroeconomic news boosting price by only \$5, in which case the misstatement had no effect on the plaintiff's welfare. The hypothetical, Coffee says, illustrates the danger of "'phantom losses' that have no corroboration in actual market movements." *Id.* In his example in a case resembling the first situation described above, however, prior to the announcement of the truth, the price would rise by \$15, but it would lose \$10 of that \$15 gain upon announcement of the truth. In such a case, the fact that the price at time of suit is \$5 higher than at time of purchase presumably should not cause Professor Coffee concern about "phantom" losses.

91. See *supra* Part IV.B.4.

the second and third situations. Thus, this plaintiff's proof problems are essentially identical to the proof problems of the plaintiff under this changed assumption in the second and third situations discussed just above, and the analysis set out just above is equally applicable to this modified version of the fourth situation. If courts use some kind of bright line rule in these modified second and third situations, they should use the same bright line rule here.

V. THE COURT'S REASONING IN *DURA*

The Court describes the Ninth Circuit's holding concerning what a securities fraud plaintiff needs to establish to prove "that the defendant's fraud caused an economic loss" as simply "that 'the price' of the security 'on the date of purchase was inflated because of the misrepresentation.'"⁹² The Court rejects this holding, stating "[i]n our view, the Ninth Circuit is wrong"⁹³ and concluding "[n]ormally, in . . . fraud-on-the-market cases . . . an inflated purchase price will not itself constitute or proximately cause the relevant economic loss."⁹⁴ The Court gives a number of reasons for reaching this conclusion. These reasons, when subject to scrutiny, appear to be rather confused and so they unfortunately do not provide much helpful guidance concerning how future courts should decide the open issues delineated above.

A. *An Inflated Price Results in No Loss at Time of Purchase*

The Court states that "as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value."⁹⁵ The Court is thus apparently equating the value of a share at any moment in time to its market price at that time even when that price has been distorted by a misstatement. This rather slippery use of the term "value" is apparently based on the idea that the plaintiff could at the moment of a security's purchase turn around and resell it at the same price as he bought it. Using "value" in this way is contrary to one of the fundamental building block concepts in modern corporate finance, where the "value" of a share means the expected dividends and other distributions, discounted to present value, that the holder or holders of the share, whoever that may be over time, will receive during the life of the issuing firm.⁹⁶ It also ignores that the primary purpose of the securities laws, including its anti-fraud provisions, is to promote economic efficiency and fairness by trying to minimize the gap between price and value as it is understood in this corporate finance sense. The market, with its capacity to digest information possessed by many different participants relevant to predicting what the issuer's future dividends and other distributions will be, is a very powerful appraiser of value, but not when price is distorted by a material misstatement. More accurate share prices, i.e., prices that are closer to their fundamental values, enhance the efficient functioning of our economy by being better signals of where scarce

92. *Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627, 1629 (2005) (emphasis in the original, citation omitted).

93. *Id.*

94. *Id.* at 1631.

95. *Id.* (emphasis omitted).

96. BREALEY, MYERS & ALLEN, *supra* note 9, at 61-65.

capital should flow and aiding in the mechanisms that provide appropriate discipline and incentives to management. Fairness is also related to minimizing the differences between price and fundamental value. The Court's equating of value with price obscures the fact that while the plaintiff might be able instantly to turn around and sell for the same inflated price that he paid, eventually the truth will come out and eliminate the inflation. Thus, someone will be left holding the bag, having paid the premium but not able to resell at the premium.

The Court's use of the term value is odd for a second reason as well. Fraud-on-the-market suits are also available to sellers who sell at a price that has been depressed due to a negative misstatement. It seems unlikely that the Court would say the depressed price that the plaintiff received in such a case equaled the value of the share she gave up because she could have instantly turned around and repurchased the share for the same deflated price. Presumably the Court would recognize that the plaintiff suffered a loss at the time of sale unless she in fact repurchased her shares at that same deflated price before the market realized the true situation. This hypothetical concerning a plaintiff seller and a negative misstatement is completely symmetrical to one involving a plaintiff purchaser and a positive misstatement, and there is no apparent rationale for treating them differently.

The Court's suggestion that a share's value equals its price is also at odds with established securities law when it comes to the calculation of damages. The standard measure of damages in Rule 10b-5 actions, including the Court's own jurisprudence on the matter, is the "out of pocket" measure, i.e., the extra amount the plaintiff pays at the time of purchase because of the misstatement (assuming no resale at a price that is still inflated by the misstatement to one extent or another).⁹⁷ This measure of damages could hardly be appropriate if value equals price at the time of purchase.

B. No Inevitable Link Between an Inflated Share Price and Later Economic Loss

Having dismissed the idea that a loss could occur at the time of purchase, the Court argues that there also might not be a loss later either, saying, "the logical link between the inflated share price and any later economic loss is not invariably strong."⁹⁸ In support of this second argument, the Court starts with the observation, "if, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss."⁹⁹ It is certainly true, as already discussed, that it would be a mistake to grant damages to such a purchaser. The reason for not granting damages, however, is not that the purchaser did not incur an injury at the time of purchase as a result of defendant's wrongful misstatement; he did suffer an injury by having to pay more than he otherwise would have but for the misstatement. The reason for not granting damages is that the purchaser has received a benefit arising from the same wrong in an amount equal to the injury he suffered earlier. Indeed, a bar on the payment of damages to the extent that the plaintiff recoups his injury by sale at a still inflated price is exactly

97. *Randall v. Loftsgaarden*, 478 U.S. 647, 662 (1986); *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 532 (10th Cir. 1962); 10 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4412-13 (3d ed. rev. 2004).

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

99. *Id.*

the Ninth Circuit rule on damages, one set out by Judge Sneed in his concurring opinion in *Green v. Occidental Petroleum Corp.*,¹⁰⁰ which is a standard textbook case on the matter. Thus, any implication in the Court's opinion that the Ninth Circuit's holding in *Dura* would have led to such a purchaser receiving damages is unfounded.

The Court then goes on to deal with the situation where the purchaser does not sell until after truth has come out:

If the purchaser sells later after the truth makes its way into the market place, an initially inflated purchase price might mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect . . . other events.¹⁰¹

Here the Court is simply wrong. If the truth makes its way into the market, the initially inflated price will inevitably result in a loss. Whether it is the original purchaser of the share or some later one, some investor will be unambiguously economically disadvantaged because the misstatement inflated his purchase price. The investor who purchased the stock when its price was inflated and who is still holding it when the truth comes out will have paid more for the share than he would have but for the misstatement and will not be able to recoup this injury by selling at a similarly inflated price. This is because the efficient market hypothesis, the foundation on which the fraud-on-the-market theory is built, assures us that once the truth comes out, the price will no longer be inflated.

The rationale that the Court provides for its incorrect conclusion involves some odd form of backward reasoning. The issue the Court was purporting to address was not whether every misstatement that at some point later is followed by a price drop inevitably means that the misstatement has caused a loss. That is obviously not true: the misstatement might not have inflated price in the first place and the drop would therefore have to be the consequence of some unrelated factor, not the dissipation of inflation. The issue the Court was purporting to address was whether there is inevitably a loss where price was inflated by a misstatement and the truth later came out. The fact that not every price drop is evidence that price has been inflated by a misstatement is irrelevant because the proposition the Court was exploring assumed the price was inflated. While the statement clearly fails logically to support the Court's conclusion that price inflation due to a misstatement followed by the truth coming out does not inevitably lead to a loss, it probably does reflect the Court's appropriate concern with the reliability of evidence used to establish that a price was inflated in the first place.

C. The Ninth Circuit Holding Lacks Precedent

The Court also criticized the Ninth Circuit holding as "lack[ing] support in precedent."¹⁰² When past cases are examined carefully, however, there is not much precedent relevant to what needs to be shown to establish causation in a fraud-on-the-market case. This lack of precedent going either way is hardly surprising given how new the cause of action is. The precedent that does exist is, in fact, fairly evenly split.

100. *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1341-46 (9th Cir. 1976).

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

102. *Id.* at 1632.

The Court starts by referring to what needs to be shown to establish causation in common law deceit actions.¹⁰³ The cases and commentary that it refers to, however, relate to traditional reliance-based actions, since the fraud-on-the-market theory is not a common law doctrine. As discussed in Parts I and II, the causal link between the defendant's wrongful act and the plaintiff's injury is entirely different in a traditional reliance-based action than in a fraud-on-the-market action. Therefore, the common law cases on causation provide very little meaningful guidance to the question before the Court. The Court's review of circuit court federal securities law Rule 10b-5 opinions suffers to some extent from a similar problem. Two of the four cases cited, *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*¹⁰⁴ and *Bastian v. Petren Resources Corp.*,¹⁰⁵ are traditional reliance-based actions, not fraud-on-the-market actions.

When it comes to actual fraud-on-the-market cases, the Court cites only one case, *Robbins v. Koger Properties, Inc.*,¹⁰⁶ that holds that a showing that the price at the time of purchase was inflated by the misstatement is insufficient to constitute loss causation.¹⁰⁷ And while the Court refers to the "uniqueness" of the Ninth Circuit's perspective on this question,¹⁰⁸ it fails to note that the Eighth Circuit had adopted the same rule as the Ninth.¹⁰⁹

VI. RESOLVING THE OPEN ISSUES

This Article has identified two large questions left open by the Court's decision in *Dura*. The first is whether a plaintiff would ever be allowed to establish that a misstatement caused a loss in a situation where the price at the time suit is brought (or, if earlier, the time of sale) is higher than the purchase price. The second concerns what, for purposes of pleading, would, beyond the allegation that the misstatement inflated the purchase price, constitute a sufficient "indication of the loss and the causal connection"

103. *Id.*

104. *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003).

105. *Bastian v. Petren Res. Corp.*, 892 F.2d 680 (7th Cir. 1990).

106. *Robbins v. Koger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997). *Robbins*, which is not a very persuasively argued case, is discussed in more detail in Part II.C.3 *supra*. The Court, in addition, cites *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000), which is also a fraud-on-the-market case. *See Dura*, 125 S. Ct. at 1632. In *Semerenko* the Third Circuit in *dicta* appears also to reject the inflation theory of loss causation, stating "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." *Semerenko*, 223 F.3d at 185. The *Semerenko* court's concern is that "[w]here the value of the security does not actually decline as a result of an alleged misrepresentation . . . 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." *Id.* at 185. The court made this statement to suggest that earlier Third Circuit opinions that appeared to adopt the price inflation theory of loss causation might be wrong. What the Third Circuit rule is at this point was not tested by this case, however, since the court found that the complaint alleged that the stock involved "was 'buoyed' by the defendants [sic] alleged misrepresentations, and that it dropped in response to disclosure of the alleged misrepresentations . . ." *Id.* at 186. So the appellate court would have vacated the district court's grant of defendants' motion to dismiss under either approach.

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

108. *Id.*

109. *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

and what, for purposes of proof at trial, would constitute the kind of evidence sufficient to establish that there had been an inflation in price that proximately caused an economic loss. I will address each of these issues specifically and then consider some larger questions relevant to their resolution.

A. Price at Time of Suit Higher than Purchase Price: Limiting Recovery to Actual Losses

There should not be a blanket rule barring damages in fraud-on-the-market suits where the price at the time suit is brought (or, if earlier, the time of sale) is higher than the purchase price or, more generally, limiting recoveries to actual ex post losses. Such a rule would be a relic carried over without reason from traditional reliance-based actions, where, unlike fraud-on-the-market actions, there is some rationale for a focus on ex post losses.¹¹⁰

1. Case Where Misstatement Clearly Inflated Plaintiff's Purchase Price

In a case where the price at the time of suit is higher than the purchase price, but where it is clear that the misstatement inflated the plaintiff's purchase price and that she has not recouped her injury through a sale prior to complete market realization of the true situation, the defendant's misstatement has unquestionably made her worse off in an amount equal to its inflation of purchase price. But for the misstatement, she would have paid exactly that much less for the share, and received in return the same share with the same value. A rule prohibiting compensation in such a case would result in a lack of balance in outcomes depending on whether, after the purchase, other news affecting the fortunes of the issuer, unrelated to the misstatement, is positive or negative.¹¹¹ Investors

110. See *supra* Part I.B.

111. A requirement of limiting recovery to actual losses, as an application of the traditional loss causation requirement to fraud-on-the-market case would do, poses problems even when the sale price is less than the purchase price, if the difference is not as much as the amount by which the misstatement inflated price. The following examples illustrate the point. In the first example, XYZ corporation violates Rule 10b-5 by falsely announcing on June 1 a large increase in the sales of its food division. This inflates XYZ's share price by \$10, resulting in its shares trading at \$60 instead of \$50. Later the same day, *A* buys a share in the secondary market at the \$60 price. Two things happen thereafter during the month of June: the Bolivian government confiscates XYZ's mineral properties in Bolivia (part of a business unrelated to food) and the market realizes the truth about the food division's sales. As a result, by July 1, the price has gone down from \$60 to \$30 (i.e., the confiscation subtracts \$20 from the price and the realization of the truth about the food sales subtracts another \$10, for a total decline of \$30). On July 1, suit is brought. *A* has not sold. Under the approach advocated here, *A*'s loss due to the misstatement is \$10 because the misstatement caused him to pay \$10 more than he otherwise would have. He would receive no compensation for the additional \$20 because what happens to the share price after the purchase is irrelevant to his injury. Application of the traditional loss causation theory would also result in the same \$10 loss from the misstatement, but the reasoning would be very different: *A* suffers a loss because of the \$30 price drop, but only \$10 is considered caused by the misstatement because the other \$20 in decline is not a reasonably foreseeable consequence of the misstatement.

In the second example, all the facts are the same except that in June, XYZ, instead of being a target of a Bolivian confiscation, discovers oil in Indonesia. By July 1, the price has only gone down to \$55 (i.e., the oil discovery adds \$5 to the price and the market realization of the truth about the food sales subtracts \$10, for a net loss of \$5). Under the approach recommended here, *A* again has incurred a \$10 loss because the misstatement caused him to pay \$10 more than he otherwise would have for shares. Application of the traditional loss causation requirement, in contrast, would result in the recognition of \$5 in loss because that is all that the price has gone down.

would have to suffer the full downside risk associated with unrelated bad news. They would not be able, however, to enjoy fully the upside risks associated with unrelated good news, because any such gains would cancel out, where present, their otherwise valid cause of action for damages from a misstatement that inflated their purchase price. This lack of balance in outcomes is not only arbitrary, it is inefficient. It distorts incentives for investors who seek to profit through hard work by anticipating, ahead of the market, both good and bad news events. Such activities are socially useful because they help improve the accuracy of share prices. More accurate prices help allocate scarce capital to the most promising investment projects and assist in the mechanisms that discipline management and provide incentives.

2. Case Where it is not Clearly Established that the Misstatement Inflated Plaintiffs' Purchase Price

Now consider the situation where the plaintiff has not clearly established one or more of the essential elements causally linking the misstatement to a loss, i.e., that the misstatement inflated the issuer's share price in the first place, that some or all of the inflation still remained when the plaintiff made her purchase, and that the inflation still present at the time of purchase had dissipated in part or in whole by the time of sale. In such a situation the fact that price at the time suit is brought (or, if earlier, the time of sale) is higher than the purchase price has some probative value. At a minimum it is negative evidence that should be weighed against whatever affirmative evidence the plaintiff introduces with regard to these elements. Moreover, as discussed in Part IV, there is a rationale for bright line rules triggered by this fact that would bar damages under some circumstances. In deciding how compelling the rationale is for adopting any such bright line rule, however, the lower courts should bear in mind that the arbitrariness and inefficiencies that would result from a blanket rule that never allows recovery when the price at time of suit (or earlier sale) is greater than the purchase price would still, to some extent, be present as well with more narrowly tailored bright line rules applicable in only certain situations. Such rules are bound to cut out some cases where in fact the misstatement did inflate the price.

B. Sufficient Pleadings and Proofs at Trial That the Misstatement Caused a Loss

A threshold question is whether it is necessary for the plaintiff to plead and prove a

As noted in the text, requiring the same loss causation showing in fraud-on-the-market cases as in traditional reliance based cases results in a lack of balance in outcomes depending on whether, after the purchase, other news affecting the fortunes of the issuer is positive or negative. Investors must suffer the full downside risk associated with bad news. If Bolivia confiscates XYZ's mineral properties, as in the first example above, *A* suffers the full \$20 loss associated with the confiscation, since his right of recovery is still limited to \$10, the amount by which market realization of the truth concerning the food division sales depressed the price. Under this approach, investors cannot, however, fully enjoy the upside risks associated with good news, because any such gains will be eroded by market realization of the truth. If XYZ instead discovers oil in Indonesia, as in the second example above, *A*'s damages would be \$5 since that is all that the price declined. *A* receives none of the \$5 that the good news is worth. He would be able to sell the security for \$55 and receive \$5 in damages for a total of \$60, exactly what he paid. In contrast, under the approach recommended here, *A* would enjoy the full \$5 value of the good news. He could sell the security for \$55 and receive \$10 in damages, for a total of \$65, \$5 more than he paid.

price drop immediately following the public announcement of the truth. The discussion in Part IV suggests that such a requirement, while it has a rationale, would be too strict and that the plaintiff should be able to introduce at least some other kinds of evidence showing that the purchase price had been inflated by the misstatement and that the market had later realized the true situation, thereby dissipating this inflation. To start, an immediate significant increase in share price following a misstatement is as good evidence that the misstatement inflated price as a significant price drop following a public announcement of the falsity of the misstatement. Even if there is no price drop following the public announcement, a plaintiff who purchased right after such a misstatement was made and was still holding after the unambiguous public announcement of the falsity of the misstatement is very likely to have suffered a loss. The share price increase after the misstatement was made is a very strong indication that it inflated the plaintiff's purchase price. The public announcement of the truth while she is still holding the shares assures that the inflation has fully dissipated and that she cannot recoup her injury by a resale at the inflated price.

Limiting recovery to cases where there is either a price drop after the public announcement or an increase at the time the misstatement is made has an attractive simplicity. Nevertheless, there are good arguments for allowing a plaintiff to submit less definitive kinds of evidence at least under some circumstances. Market realization of the true situation by another route in advance of an unambiguous public announcement of the falsity of a misstatement is not uncommon and many price inflating misstatements would not be actionable if less definitive evidence were prohibited.¹¹² Moreover, a blanket rule against submission of such less definitive kinds of evidence would encourage an issuer that made a misstatement to let the truth out slowly over time in bits and pieces so that no single announcement has a market adjusted price drop associated with it sufficiently large to be statistically significant. I have discussed in Part IV plausibly available kinds of evidence that could be quite persuasive as to importance of the misstatement, its acceptance as true by the market, and how the market realized the true situation prior to the public announcement. I also suggested that in the typical class action, at least a portion of the shares were purchased at time of misstatement or close enough to it that no dissipation of any inflation is likely to have occurred. As far as damages owed to the class as a whole is concerned, these shares are like the shares of persons in the second situation as originally portrayed in Part IV, who purchased right after the misstatement and still held the shares at the time suit was brought (which is after the inflation, if any, was fully dissipated). Thus, if the lawyers for the class can make a persuasive argument that there was an initial inflation of price, then clearly, in the aggregate, members of the class suffered at least some losses as the result of the misstatement regardless of the time

112. As previously noted, the United States Solicitor General and the SEC urged the Supreme Court to reverse the Ninth Circuit ruling in *Dura*. In their brief arguing for a grant of certiorari, they draw a distinction, as ultimately does the Court and as is done here, between an investor who purchases a share whose price has been inflated by a misstatement and sells while the price is still inflated and an investor who does not sell "until the market price reflects the true facts that had been concealed by the fraud." In terms of how the market comes to reflect these facts, interestingly the brief says: "This will most commonly occur when the truth is revealed in whole or in part through a corrective disclosure. That, however, is not the only way fraud may be revealed. Events may also effectively disclose the truth." Cert. Pet. Amicus Brief of the United States, *supra* note 74, at 11.

and rate of dissipation of the inflation between the making of the misstatement and the public announcement.

If less definitive kinds of evidence are allowed, the pleading standards need to be carefully thought through. The Court stated that “ordinary pleading rules are not meant to impose a great burden upon a plaintiff . . . [b]ut it should not prove burdensome . . . to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.”¹¹³ Perhaps a bit more ominously for plaintiffs, it also said it would “assume, at least for argument’s sake, that neither the Rules [of Civil Procedure] nor the securities statutes impose any special further requirement” beyond the Federal Rules of Civil Procedure Rule 8(a)(2) requirement of “a short and plain statement of the claim showing that the pleader is entitled to relief.”¹¹⁴ Ultimately, though, whether this standard is met depends on the contours of what needs to be proved at trial. The pleading with respect to the self-evident importance of the misstatement under the assumption that it is reliable should be satisfied if it is facially material. In essence, the Court already accepted this idea when it blessed the fraud-on-the-market theory in *Basic*. Evidence concerning the market acceptance of the misstatement as true should be available to plaintiffs without discovery and so requiring specific allegations with respect to this matter would not necessarily be very burdensome. Evidence supporting an explanation of how the market realized the true situation prior to the unambiguous public announcement may be more difficult to obtain. Moreover, as we have seen, for some plaintiffs—ones who purchased right after the misstatement was made and were still holding their shares when suit is brought—and for class action lawyers showing that at least some damages are owed to the class, a persuasive showing of the importance of the misstatement and its acceptance as true by the market can substitute for a complete explanation of how the market realized the true situation. Thus, at least in these kinds of cases, a requirement of specific allegations with regard to this explanation seems unwarranted.

C. The Relevance of the PSLRA

The Private Securities Litigation Reform Act (PSLRA) added section 21D(b)(4) to the Securities Exchange Act of 1934 (Exchange Act). This provision is entitled “Loss Causation” and provides that plaintiffs in private actions “shall have the burden of proving that the act or omission of the defendant . . . caused the loss for which the plaintiff seeks to recover damages.”¹¹⁵ The government argued before the Court in *Dura* that this provision codifies the need for plaintiffs in fraud-on-the-market cases to establish traditional loss causation with the requirement of a discrete drop in price after an unambiguous announcement of the falsity of the misstatement and a limit on recovery equal to the difference between the purchase price and the sale price.¹¹⁶ The weakness of this argument is that it begs the question of what is the loss with respect to which causation must be shown. The approach advocated in this Article is that for fraud-on-the-market cases, the loss with respect to which the plaintiff must show causation is the inflation in the price the plaintiff paid minus the amount, if any, by which share price at

113. *Dura*, 125 S. Ct. at 1634 (citation omitted).

114. *Id.*

115. 15 U.S.C.A. § 78u-4(b)(4) (2005).

116. *See, e.g.*, Cert. Pet. Amicus Brief for the United States, *supra* note 74, at 10-13.

time of suit (or, if earlier, sale) is still inflated.

The language of section 21D(b)(4) is fully consistent with the concept that the loss the plaintiff must show was caused by the defendant's misstatement is that the misstatement resulted in her paying too much for the security.¹¹⁷ Indeed, in section 21D(b)(4), the "loss" that is referred to is "the loss for which the plaintiff seeks to recover damages" and, as noted earlier, the out-of-pocket measure of damages is the measure conventionally applied by courts in Rule 10b-5 actions. Price inflation is the type of loss that most closely corresponds with this measure of damages. Moreover, the PSLRA's legislative history supports the conclusion that a showing of price inflation satisfies the requirements of section 21D(b)(4). The Conference Report, in explaining that the purpose of section 21D(b)(4) is to require the plaintiff to plead and prove that the misstatement "actually caused the loss incurred by plaintiff" goes on to say "[f]or example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as a result of the misstatement."¹¹⁸ In terms of the range of meanings of the term "loss causation" that may have been contemplated by Congress, it is also significant that there existed appellate decisions prior to the passage of the PSLRA holding that a showing of price inflation is sufficient to demonstrate loss causation.¹¹⁹

117. The government seeks to deny that this is a reasonable reading of the provision by stating "[a] loss is a decline in value, and in a fraud-on-the-market case, that necessarily occurs at a point in time *after* the purchase." Amicus Brief for the United States, *supra* note 74, at 7-8 (emphasis in the original). This narrow interpretation of the word "loss" seems contradicted by the government elsewhere in this same brief and in its own earlier brief in support of the defendant's certiorari petition. In these briefs, the government makes statements such as "the inflation attributable to the untruth . . . could also be removed through an increase in the price that is smaller than it otherwise would have been." *Id.* at 7. "A decline in price may not be a necessary condition for loss causation, however, because the inflation attributable to fraud could be reduced or eliminated even if there were a net increase in price." Cert. Pet. Amicus Brief of the United States, *supra* note 74, at 13. An additional problem with this narrow reading of "loss" arises in the case of a fraud-on-the-market suit by a plaintiff who sold shares of an issuer for less than he otherwise would have received because of a negative misstatement on the part of the defendant and never repurchases the shares. See *supra* note 8. According to the logic of the narrow definition, even though the plaintiff never repurchases, he does not suffer a "loss" until after market realization of the truth. Such a conclusion defies common sense.

118. H.R. REP. NO. 104-369, at 41 (1995). In terms of Congressional intent concerning the meaning of the word "loss" in § 21D(b)(4), the government argues that notwithstanding this example, Congress must have intended to require a showing of a loss after purchase because the PSLRA also added to section 12 of the Securities Act of 1933 (the "Securities Act"), a provision which it also referred to as relating to "loss causation." The addition to section 12 enables a defendant to reduce liability to the extent that he can show that the amount otherwise recoverable represents "other than the depreciation in value of the . . . security" resulting from the misstatement. The government states, "there is no reason to believe that Congress had two different standards of loss causation in mind when it enacted the PSLRA." Amicus Brief of the United States, *supra* note 74, at 8. The problem with the government's argument is that the *prima facie* measure of damages in a section 12 claim is recessionary: the difference between the price paid and the price at the time of suit. Thus any loss causation limitation on section 12 damages would inevitably have to be phrased in terms of a reduction in damages so measured. In contrast, the ordinary measure of damages in a Rule 10b-5 action is the out of pocket measure and hence there is no need to phrase a limitation on these damages in terms of a depreciation in the value of the security.

119. See, e.g., *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619-20 (8th Cir. 1991) ("To the extent that the defendant's misrepresentations artificially altered the price of the stock and defrauded the market, causation is presumed.").

D. Should Fraud-on-the-Market Suits Be Discouraged by a Restrictive Rule of Causation

Some academic commentators have indicated a preference for fairly restrictive rules relating to causation. My colleague, Professor John Coffee, for example, based on his doubts about the overall desirability of fraud-on-the-market suits in the first instance, argues, akin to loss causation in traditional reliance based cases, that a discrete drop in price after an unambiguous announcement of the falsity of the misstatement should be required and that recovery should be limited to the difference between the purchase price and the sale price.¹²⁰ He argues that these more restrictive rules would limit the number of fraud-on-the-market actions. Limiting the number of actions is desirable because it means limiting amount of associated transaction costs.¹²¹ These costs are primarily the fees that both sides pay to the legal profession, costs that are ultimately borne largely by shareholders. Coffee points out, correctly, that in the secondary market trading cases, where fraud-on-the-market causes of action arise, the losses by the plaintiff purchaser, who pays too much, are counterbalanced by the gains of the seller, who receives too much.¹²² The seller is usually also an outside investor, unrelated to the suit, who is equally in the dark. From a societal point of view, therefore, because issuers pay most of the damages and thus they ultimately come from the pockets of issuer shareholders, fraud-on-the-market suits primarily redistribute wealth among innocent investors. Accordingly, Professor Coffee feels that the compensatory justification for such suits is weak,¹²³ a conclusion with which I tend to agree.

Fraud-on-the-market actions can have an efficiency justification as well, however, and this justification may be much stronger than the compensatory justification. As Professor Coffee acknowledges, such actions deter corporate misstatements,¹²⁴ something Bob Clark noted in his treatise even in the advanced of the explosion of corporate misstatement cases following *Basic*.¹²⁵ A lower level of corporate misstatements increases share price accuracy. Greater share price accuracy makes the economy more efficient through improvements in how new projects in the real economy are selected for implementation and, by increasing the effectiveness of a number of devices that limit the extent to which managers of public corporations place their own interests above those of their shareholders, through improvements in how existing projects are run.¹²⁶ An expectation of a lower level of corporate misstatements also

120. John C. Coffee, Jr., *Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse Broudo*, 60 BUS. LAW. 533, 537 (2005).

121. *Id.* at 542.

122. *Id.* at 534.

123. *Id.* at 542-43.

124. *Id.* at 543.

125. CLARK, *supra* note 5, at 345.

126. See Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment*, 85 VA. L. REV. 1335, 1358-69 (1999). Professor Robert Thompson, in an article also relating to *Dura* published in this issue, expresses some reservations concerning the use of securities fraud suits to perform these functions, saying "state law of fiduciary duty and the deference inherent in the business judgment rule provide both a check on possible management abuse of their authority and considerable room for management to make decisions free of second-guessing by courts." Robert B. Thompson, *Federal Corporate Law: Torts and Fiduciary Duty* (2006) (unpublished manuscript, on file with the Journal of Corporation Law). Because of the way fraud-on-the-market suits deter managerial abuse, however, it is not clear that they really deprive management of the room they need to make decisions or give courts an ability to second guess management's

lowers investor precaution costs, the resources secondary market traders and their advisors expend trying to detect misstatements so as to avoid losing transactions.

The question of the role of private civil damages litigation in deterring issuer misstatements in situations where neither the issuer nor its insiders engage in significant trading is a complicated one. It involves a variety of rules beyond causation requirements, including, among others, rules determining how difficult it is to sue various potential defendants (issuers, directors and officers, control shareholders, accountants, etc.), the amounts that such defendants would be expected to pay out in damages, and the fees to plaintiffs' class action lawyers. Mandatory periodic disclosure rules and rules concerning related issuer, officer and gatekeeper liability rules are relevant as well. In addition to deterring misstatements, the design of this whole complex of rules needs to be concerned with the incentives of issuers to make truthful statements in situations where there is no duty to disclose and with the incentives of different kinds of investors to gather, analyze and act on information.¹²⁷ It is desirable to have a set of rules that, working together, encourage suits where the efficiency benefits exceed the costs and that discourage suits where the opposite is the case.

Personally, I believe that the prevailing set of rules is not perfect. It encourages some kinds of suits where the costs exceed the deterrence value and discourage some other kinds of suits where their deterrence value would exceed their costs. Imposition of a traditional loss causation rule in fraud-on-the-market suits does not appear to be a rational way of remedying this problem, however. It will arbitrarily cut out plaintiffs in cases where positive news unrelated to the misstatement has counterbalanced the effect on price from the market realization of the misstatement. There is no reason to think that the deterrence value of these cases is any less, or their costs any greater, than those of cases where traditional loss causation can be demonstrated. It will also cut out all cases where there is no drop in price after the unambiguous announcement of the falsity of the misstatement. This seems arbitrary with respect to cases where there is other clear evidence of price inflation. Again, compared to cases where traditional loss causation can be demonstrated, the deterrence value should be no less and, as explored here, the costs should not be dramatically greater.

E. The Assumption of Constant Impact

I assume throughout this Article that the facts asserted by the misstatement would, if they had been true, have had a constant impact on the underlying fundamental value of an issuer's shares. For many kinds of misrepresentations, this assumption is a reasonably close approximation of reality. To illustrate, consider issuer *A*, with 5 million shares outstanding, that falsely stated that it had an extra \$60 million in cash in its treasury. If

substantive decisions. Fraud-on-the-market suits deter managerial behavior only indirectly, by encouraging honesty in disclosure. Abuse that cannot be hidden is abuse that will probably not be undertaken. It is not a court's view of what constitutes abuse that managers fear, however, it is the market's and the public's views. While it is true, as Thompson points out, that a management that chooses to abuse is likely to make an actionable misstatement to hide it, the court simply has to judge whether a material misstatement has been made, not whether the underlying behavior constitutes abuse or not.

127. See Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation* (Columbia Law and Economics Working Paper No. 259, 2004), available at <http://ssrn.com/abstract=600709> (discussing civil liability rules with regard to incentives on investors).

the issuer had really had this \$60 million in cash in the treasury at the time of the original misstatement, the fundamental value of each share would have been increased by \$12. The same would be true if the issuer had really had this \$60 million in the treasury at the time of the announcement of the truth.

For other kinds of misstatements, this assumption of constant impact is not a reasonable approximation of reality. To illustrate this second kind of misstatement, consider issuer *B*, also with 5 million shares outstanding, that falsely stated that it had an extra one million barrels of oil in storage. If the issuer had really had this one million barrels of oil at the time the misrepresentation was made and the price of oil was \$60, the fundamental value of each share would again have been increased by \$12. Suppose, though, that between the time of the misstatement and the time when the truth was announced, the price of oil decreased to \$50 per barrel. By the time of the announcement of the truth, then, if the issuer had really had this one million barrels of oil in storage, the fundamental value of each share would have been increased by only \$10. Thus, the impact of the facts asserted by the misstatement on the underlying fundamental value of an issuer's shares, which remained constant in the first example, dropped by \$2 in the second example.

I employ the constant impact assumption because, despite its deviation from reality with regard to this second type of misstatement, it simplifies the discussion of the most important issues related to loss causation without serious loss of generality. For some kinds of cases, the lack of reality in the assumption has no impact at all on the analysis. Consider again the misstatements by issuer *A* and issuer *B* in the context of cases resembling the first or second situations discussed in Part III, where an investor buys immediately after the misstatement and holds the shares until after the public announcement of the truth. An investor who buys a share of *A* pays \$12 more per share than he would have but for *A*'s misstatement, and the same is true of an investor who buys a share of *B*.¹²⁸ As a consequence, the misstatement caused each of the investors a \$12 loss. This is because each paid \$12 too much and each did not recoup any of this loss by selling at a price that was to any extent still inflated by the misstatement.

Where an investor purchases later than immediately after the misstatement and/or sells before the market fully realizes the true situation, the assumption of constant impact may be more problematic, but it still has a rationale. This is because the EMH guarantees that the impact of the facts asserted by the misstatement on the underlying fundamental value of an issuer's shares at the time of the misstatement is an unbiased estimate of this impact at any point in the future as well. In other words, the value that the market would assign to each share of *B* at the time of the misstatement reflects both the chance that the price of oil in the future might go up and the chance that it might go down. As a consequence, it would not be unreasonable to have a rule that there is no loss in the case of an investor in our example who purchased a share of *B* immediately after the oil misstatement, when, if fully believed, it inflated the price by \$12, and who sold shortly before the announcement of the truth, when, if the misstatement was still fully believed, it inflated the price by only \$10. The value the market assigned to this nonexistent oil at the time of the investor's purchase reflected the possibilities both that the price of oil might

128. In each, for purposes of expositional convenience, I am assuming that the market fully believes the misstatement at the time it is made. This assumption is not necessary for the point to hold.

go up, which at time of sale would have resulted in a share price inflation of more than \$12, as well as might go down. Thus, it can be argued, while the misstatement is a but for cause of the \$2 shortfall, it is not a proximate cause. This is because at the time the investor purchased the share, the misstatement, if the investor were to sell before market realization of the truth, was as likely to have resulted in a gain from an increase in the amount the misstatement inflates price as to have resulted in a loss from a decrease in the amount the misstatement inflates price. Under this argument, it is the decrease in the price of oil, not the issuer's misstatement, that is the legal cause of the \$2 shortfall. *Dura* does not decide whether an economic disadvantage at time of sale arising out of a fall in the underlying value of a falsely claimed asset, such as this \$2 shortfall, should be considered a loss caused by the misstatement. Cases may arise, of course, that require resolution of this question, but beyond my observation that a reasonable argument could be made that such a shortfall should not be considered a loss, I do not pursue the issue further here. The constant impact assumption helps us keep our focus on what I believe are the two most important questions for loss causation—did the misstatement inflate price in the first place and has the inflation dissipated by time of sale—questions that are involved in every fraud-on-the-market case.

VII. CONCLUSION

This Article has evaluated the issues remaining open after the Court's decision in *Dura*. Analytically, in an action for damages based on the fraud-on-the-market theory, for a positive misstatement to cause an investor to suffer a loss, (1) the misstatement must inflate the market price of a security, (2) the investor must purchase the security at the inflated price, and (3) the investor must not resell the security sufficiently quickly that the price at the time of sale is still equally inflated. *Dura's* narrow holding is that a plaintiff cannot establish causation merely by pleading and proving that the misstatement inflated price. Future courts have thus been left the task of designing a comprehensive set of rules concerning what the plaintiff must plead and prove, and the acceptable forms of evidence, concerning each of these three critical elements. I have tried to suggest a number of considerations that can help them do that in a way that minimizes the conflict between the two important social aims of deterring corporate misstatements and limiting the transaction costs associated with civil litigation.

One important matter on which the Court expresses no opinion is whether loss causation can ever be established where the price at the time suit is brought (or, if earlier, at the time of sale) is higher than the purchase price. This Article concludes that a blanket rule against actions where the price has increased would be inappropriate because there are situations where the price has increased but each of the three critical elements can still be reasonably easily and definitively established. Where one or more of these elements cannot be reasonably easily and definitively established, however, a price increase is a negative piece of evidence concerning whether the misstatement inflated price and a bright line rule barring actions when price has increased might be appropriate at least under some specified circumstances.

The other important matter on which the Court expresses no opinion is whether the plaintiff must plead and prove a price drop immediately following the unambiguous public announcement of the falsity of the misstatement. Again, this Article concludes that

a blanket rule requiring such a showing is inappropriate. Other ways of demonstrating that the misstatement inflated price are sufficiently reliable that they should be allowed under at least some circumstances. The absence of a price drop after the announcement, however, makes it less clear when the inflation dissipated, which is relevant to whether the plaintiff both bought at a time when the price was still inflated (if it ever was inflated) and sold at a time when it was no longer inflated. Some plaintiffs can show these other two elements reasonably easily and definitively, for example plaintiffs who purchase the security immediately after the misstatement is made and still hold it at the time of the public announcement of its falsity. For plaintiffs whose purchase and sale timings do not fit this profile, it may be appropriate to bar actions where there is no post announcement price drop. This problem is less critical for class actions because at least minimum losses to the class as a whole can be established without concern as to when the inflation dissipated.