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## What's Brewing in *Dura v. Broudo*? The Plaintiffs' Attorneys Review the Supreme Court's Opinion and Its Import for Securities-Fraud Litigation

Patrick J. Coughlin

*Lerach Coughlin Stoia Geller Rudman & Robbins LLP*

Eric Alan Isaacson

*Lerach Coughlin Stoia Geller Rudman & Robbins LLP*

Joseph D. Daley

*Lerach Coughlin Stoia Geller Rudman & Robbins LLP*

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# What's Brewing in *Dura v. Broudo*?

## The Plaintiffs' Attorneys Review the Supreme Court's Opinion and Its Import for Securities-Fraud Litigation

*Patrick J. Coughlin, Eric Alan Isaacson, and Joseph D. Daley\**

### I. INTRODUCTION

On April 19, 2005, the United States Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*<sup>1</sup> ruled on the issue of loss causation in private actions for open-market securities fraud prosecuted under Securities Exchange Act § 10(b).<sup>2</sup> The issue in *Dura* was a narrow one: whether a complaint only alleging *price inflation* due to a material misrepresentation or omission sufficiently pleads loss causation. Reversing a Ninth Circuit holding that an inflated purchase price by itself sufficiently establishes loss causation,<sup>3</sup> the Supreme Court ruled that defrauded investors must instead plead and then prove that a misrepresentation proximately caused an economic loss.<sup>4</sup> The Court held that to state a claim, plaintiffs' pleadings must provide defendants with fair notice of plaintiffs' claim of loss.<sup>5</sup>

A case can be made that the Supreme Court should have endorsed the Ninth Circuit's longstanding rule that loss causation is adequately pleaded with nothing more than allegations that false representations—disseminated in the open market—injured investors when they paid too much for a security, by purchasing it at an artificially inflated price.<sup>6</sup>

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\* The authors are partners in the law firm of Lerach Coughlin Stoia Geller Rudman & Robbins LLP who represented the plaintiffs before the Supreme Court in *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627 (2005). Mr. Coughlin argued the case on January 12, 2005.

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

2. 15 U.S.C. § 78j(b) (2000).

3. *Broudo v. Dura Pharm., Inc.*, 339 F.3d 933, 937 (9th Cir. 2003), *rev'd* 125 S. Ct. 1627 (2005).

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

5. *Id.* at 1634.

6. *See, e.g., Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (finding that “[I]n a fraud-on-the-market case plaintiffs establish loss causation if they have shown that the price on

But whether or not the Court adopted the best possible rule is, for practitioners, largely beside the point. For good or ill, its decision is law. This article, accordingly, focuses not on what the Supreme Court perhaps ought to have done, but on what it in fact did and the consequences for investors.

The Court resolved an apparent conflict among the circuits by setting down a uniform rule of law. To do this, it chose among a variety of positions. And, although it ruled against the plaintiffs, and overturned established Ninth Circuit precedent, it by no means adopted a position that may fairly be portrayed as hostile to investors—quite to the contrary. As set forth below, the Supreme Court did not adopt draconian rules calculated to make recovery unreasonably difficult. Rather, it adopted sensible rules for pleading and proving loss causation in securities cases that should not prove overly burdensome to investors.

Part II of this article lays the groundwork for the *Dura* decision by reviewing the element of loss causation and the pleading requirements imposed by the Private Securities Litigation Reform Act of 1995 (PSLRA).<sup>7</sup> Next, Part III examines what *Dura* does—and does not—hold, in particular examining the various positions taken by *Dura* Pharmaceuticals and its amici that the Court declined to adopt.<sup>8</sup> This Part also explores the various ways loss causation can be alleged in the absence of a stock price decline following a corrective disclosure.<sup>9</sup> In addition, this article explores several arguments advanced by *Dura* amici and Professor John Coffee, a well-regarded securities-law

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the date of purchase was inflated because of the misrepresentation.”). Powerful arguments have been framed in favor of the Ninth Circuit’s approach. See generally Merritt B. Fox, *Demystifying Causation in Fraud-on-the-Market Actions*, 60 BUS. LAW. 507 (2005) (“Because of this fundamental difference in causal connection, the twin concepts of transaction causation and loss causation simply do not make sense in fraud-on-the-market actions.”); Michael J. Kaufman, *Loss Causation Revisited*, 32 SEC. REG. L.J. 357, 359–69 (2004) (discussing the elements of liability under Rule 10b-5). See also MICHAEL J. KAUFMAN, SECURITIES LITIGATION: DAMAGES §§ 11-4 to 11-8 (2004) [hereinafter KAUFMAN, SECURITIES LITIGATION] (discussing loss causation in Rule 10b-5); Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357, 365–86 (1991) [hereinafter Kaufman, *Exposing a Fraud*] (arguing that Rule 10b-5 plaintiffs should not be required to prove loss causation); Andrew L. Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suing the Remedy to the Wrong*, 66 TEX. L. REV. 469, 471–94 (1988) (explaining the development of loss causation in the context of remedies available to plaintiffs in securities-fraud cases).

7. See *infra* Part II (defining loss causation, describing its origins in case law, and reviewing the pleading standards under the PSLRA).

8. See *infra* Part III (describing the claims and defenses of the parties in *Dura*, the Court’s holding, and the arguments rejected by the Court).

9. See *infra* Part III.C.3 (describing the various ways loss causation can be alleged in the absence of a stock price decline following a corrective disclosure).

academic, that were not adopted in the Supreme Court's holding.<sup>10</sup> Ultimately, this article demonstrates that those various arguments rest upon faulty premises.

## II. BACKGROUND

### A. Loss Causation Origins in Case Law

Judge Posner has written that “what securities lawyers call ‘loss causation’ is the standard common law fraud rule . . . merely borrowed for use in federal securities fraud cases.”<sup>11</sup> And for two centuries the common law has followed the rule, articulated in *Pasley v. Freeman*, that an action for “deceit lies when a man does any deceit to the damage of another.”<sup>12</sup> Thus, in cases of fraud, if “no injury is occasioned by the lie, it is not actionable: but if it be attended with a damage, it then becomes the subject of an action.”<sup>13</sup> The Supreme Court's opinion in *Dura* represents, from one perspective, only the most recent in a very long line of cases applying this rule, that one demanding relief for fraud must draw some connection between the deceit alleged and the injury claimed.<sup>14</sup>

The Court had addressed the necessary connection between misrepresentation and loss a century before, in cases dealing with common-law fraud and market manipulation. In *Sigafus v. Porter*,<sup>15</sup> it said that where investors contend fraud induced them to purchase securities, the recoverable loss amounted to “the difference between the real value of the stock at the time of the sale and the fictitious value at which the buyer was induced to purchase.”<sup>16</sup> Ruling in *McMullen v. Hoffman*<sup>17</sup> that an anticompetitive bid-rigging contract is against public policy, the Court noted that an English case once addressed a plot “by false rumors to raise the price of the public funds and securities,” which is conduct that “strikes at the price of a vendible commodity in the market, and if it gives it a fictitious price by means of false rumors, it is

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10. See *infra* Part IV (exploring the future of securities proof and pleadings after *Dura*).

11. *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 683 (7th Cir. 1990) (citation omitted) (emphasis removed); *accord, e.g., Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997) (noting that § 10(b) “loss causation” is “nothing more than the ‘standard common law fraud rule’”).

12. *Pasley v. Freeman*, 100 Eng. Rep. 450, 457 (K.B. 1789).

13. *Id.*

14. See *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631 (quoting *Pasley*, 100 Eng. Rep. at 457).

15. 179 U.S. 116, 122–26 (1900).

16. *Id.* at 124 (quoting *High v. Beret*, 148 Pa. 261, 264 (1892) (internal quotations omitted)).

17. 174 U.S. 639 (1899).

a fraud leveled against all the public, for it is against all such as may possibly have anything to do with the funds on that particular day.”<sup>18</sup>

When Congress codified an express private cause of action for market manipulation in Securities Exchange Act of 1934 § 9(e), the statutory text was “framed specifically in favor of any person who shall purchase or sell any security at a price which was affected by [a prohibited] act or transaction.”<sup>19</sup> And when federal courts recognized an implied cause of action under § 10(b), a companion provision outlawing any “manipulative or deceptive device or contrivance” proscribed by Securities and Exchange Commission rule,<sup>20</sup> they developed, through decisional law, the elements of liability for § 10(b) claims.<sup>21</sup>

Some thought the rule for securities-fraud claims in general was clear: “In an action based upon fraud the purchaser is entitled to recover his actual loss measured by the difference between the price he paid and the value of that which he received, determined as of the time of the transaction.”<sup>22</sup> And in federal securities-fraud cases, courts often deemed the loss “recoverable by one who through fraud or misrepresentation has been induced to purchase bonds or corporate stock [to encompass] . . . the difference between the contract price, or the price paid, and the real or actual value at the date of the sale.”<sup>23</sup> When the Supreme Court, in *Affiliated Ute Citizens v. United States*,<sup>24</sup>

18. *Id.* at 649 (quoting *Rex v. De Berenger*, 105 Eng. Rep. 536 (1814) (internal quotations omitted)). The relevant loss appeared to be payment of an inflated price: “The means used are wrong, they are false rumors; the object is wrong, it was to give a false value to a commodity in the public market, which was injurious to those who had to purchase.” *United States v. Brown*, 5 F. Supp. 81, 86 (S.D.N.Y. 1933) (quoting *De Berenger*, 105 Eng. Rep. at 540 (Dampier, J.)), *aff’d*, 79 F. 321 (2d Cir. 1935)).

19. *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 46 (1977) (quoting 15 U.S.C. § 78i(e) (2000) (emphasis removed)). Congress thus “focused in § 9 upon the amount actually paid by an investor for stock that had been the subject of manipulative activity,” making the investor’s recoverable loss the “improper premium” at which the stock traded, over the price at which it would have traded absent the manipulative misconduct. *Id.* See also *Rosenberg v. Hano*, 121 F.2d 818, 821 (3d Cir. 1941) (stating that to recover under § 9(e) an investor “must either have entered a false market or paid a false price to enter a genuine market”); Kaufman, *Exposing a Fraud*, *supra* note 6, at 367–68 (noting § 9(e)’s inflated-price rule).

20. 15 U.S.C. § 78j(b) (2000).

21. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (enumerating “various positive and common-law requirements for a violation of § 10(b) or of Rule 10b-5...”); *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1627–33 (2005) (establishing the elements of a Rule 10b-5 claim).

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

23. *Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962); see KAUFMAN, *SECURITIES LITIGATION*, *supra* note 6, §§ 11-4 to 11-8 (discussing loss causation in Rule 10b-5); Kaufman, *Exposing a Fraud*, *supra* note 6, at 358 (noting cases that have developed the use of loss causation); Merritt, *supra* note 6, at 471–92 (discussing the connection between loss causation and remedies).

24. 406 U.S. 128 (1972).

dealt with claims that owners of securities had been fraudulently induced to sell them for less than their worth, the Supreme Court ruled that materiality of concealed information established the “requisite element of causation in fact,” and the investors could recover under § 10(b) “the difference between the fair value the [plaintiff] received and the value of what he would have received had there been no fraudulent conduct.”<sup>25</sup> And in *Randall v. Loftsgaarden*,<sup>26</sup> the Court observed that the precedents “have also generally applied this ‘out of pocket’ measure of damages in § 10(b) cases involving fraud by a seller of securities.”<sup>27</sup>

The Ninth Circuit concluded that in fraud-on-the-market cases, where investors contend the price for a security was manipulated by false and misleading statements and omissions, inducing them to enter transactions for the securities at an artificial and fraudulent market price, loss might consist simply in paying an inflated price—with no further showing required. Liability in such cases, the Ninth Circuit observed in *Blackie v. Barrack*,<sup>28</sup> is predicated “on a showing of economic damage (loss causation),” and reliance or “transactional causation,” which might be inferred from the fact that reasonable investors would not choose to incur a loss by buying manipulated stock.<sup>29</sup> In his concurring opinion in *Green v. Occidental Petroleum Corp.*,<sup>30</sup> Judge Sneed opined that the difference between the price paid for an artificially inflated security, and the value received, is the loss “proximately caused by the misrepresentations of the defendant[,]” and “measures precisely the extent to which the purchaser has been required

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25. *Id.* at 154–55. The Supreme Court subsequently explained:

In *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972), which involved violations of § 10(b) and Rule 10b-5 by a buyer of securities, this Court held that ordinarily “the correct measure of damages under § 28 . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct.”

*Randall v. Loftsgaarden*, 478 U.S. 647, 661–62 (1986).

26. 478 U.S. 647 (1986).

27. *Id.* at 661–62.

28. 524 F.2d 891 (9th Cir. 1975).

29. *Id.* at 906. The court explained:

We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation of the stock price when the purchase is made the causal chain between defendant’s conduct and plaintiff’s loss is sufficiently established to make out a prima facie case.

*Blackie*, 524 F.2d at 906. Thus, the required “causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock.” *Id.* at 908.

30. 541 F.2d 1335 (9th Cir. 1976) (Sneed, J., concurring).

to invest a greater amount than otherwise would have been necessary.”<sup>31</sup> And in the Seventh Circuit, Judge Posner observed that in securities cases, the term “loss causation” generally refers to the “loss produced by a discrepancy between the actual market value of a stock and what the value would have been had there been no misrepresentation[.]”<sup>32</sup>

Yet the securities-fraud precedents have never focused exclusively on inflation at the time of purchase—nor could they, as investors have often pointed to a post-purchase decline in value as the loss they wish to recover. In *Huddleston v. Herman & MacLean*,<sup>33</sup> when investors claimed they were induced by fraud to purchase a stock that later became worthless, the Fifth Circuit ruled that 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.”<sup>34</sup> The court also said that if the investors proved their case, they could recover “the difference between the price paid and the ‘real’ value of the security, *i.e.*, the fair market value absent the misrepresentations at the time of the initial purchase,” which it identified as “the loss proximately caused by the defendants’ deceit.”<sup>35</sup> Investors who claimed a post-purchase decline in price demonstrated their loss would, however, have to show that the fraud at least “touch[ed] upon” the reasons for the decline.<sup>36</sup>

The Ninth Circuit applied *Huddleston* in some cases—barring recovery where investors pointed to a decline in a security’s value to show their loss, but provided no link between the misstatements or omissions alleged and the subsequent decline in market value.<sup>37</sup> In

31. *Id.* at 1344 (Sneed, J., concurring); *see also* Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996) (affirming the district court’s jury instruction that loss causation could be found if the material misrepresentations or omissions caused the market price of the stock purchased to “be higher than it would have been if all the true facts were known....”).

32. *Isquith v. Caremark Int’l, Inc.*, 136 F.3d 531, 535 (7th Cir. 1998) (Posner, J.). Judge Easterbrook similarly observed, in *Pommer v. Medtest Corp.*, 961 F.2d 620, 628 (7th Cir. 1992), that damages under § 10(b)

usually are the difference between the price of the stock and its value on the date of the transaction if the full truth were known . . . . Sometimes this principle comes under the name “loss causation”: the plaintiff must establish that the misstatement caused him to incur the loss of which he complains; it is not enough to establish that the misrepresentation caused him to buy or sell the securities.

*Pommer*, 961 F.2d at 628 (citations omitted).

33. 640 F.2d 534 (5th Cir. 1981), *aff’d in part and rev’d in part*, 459 U.S. 375 (1983).

34. *Id.* at 549.

35. *Id.* at 554–55.

36. *Id.* at 549.

37. *See, e.g.*, *McGonigle v. Combs*, 968 F.2d 810, 820–21 (9th Cir. 1992) (quoting and following *Huddleston*, 640 F.2d at 547–49); *Binder v. Gillespie*, 184 F.3d 1059, 1065–66 (9th Cir. 1999) (quoting and following *McGonigle* and *Huddleston*).

other cases, however, the Ninth Circuit insisted that paying an inflated price by itself was enough to make out a loss—without regard to subsequent events.<sup>38</sup>

Other courts demanded more than a simple showing of inflation at the time of purchase. The Eleventh Circuit, for example, acknowledged that “[s]ome courts have held that ‘in a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation[.]’”<sup>39</sup> but construed *Huddleston* as requiring investors to give “proof of a causal connection between the misrepresentation and the investment’s subsequent decline in value.”<sup>40</sup> The Third Circuit interpreted its own precedents as holding that “where the claimed loss involves the purchase of a security at a price that is inflated due to an alleged misrepresentation, there is a sufficient causal nexus between the loss and the alleged misrepresentation to satisfy the loss causation requirement[.]” but added that the decisions “assume that the artificial inflation was actually ‘lost’ due to the alleged fraud.”<sup>41</sup> “In the absence of a correction in the market price,” the court explained, “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.”<sup>42</sup> The inflation would have to *come out* of the security’s price for investors to show a meaningful loss.<sup>43</sup> The Second Circuit similarly concluded that “allegation of a purchase-time value disparity, standing alone, cannot satisfy the loss causation pleading requirement,” emphasizing that the investors before the court satisfactorily “alleged that their investment ultimately became worthless because of the company’s liquidity crisis and expressly attributed that crisis to the executive’s inability to manage the company’s finances”—problems sufficiently related to the alleged deficiencies of the defendants’ disclosures.<sup>44</sup> A security’s decline in value on realization of

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38. *E.g.*, *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (“In a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.”).

39. *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997) (quoting *Knapp*, 90 F.3d at 1438).

40. *Id.* (citing *Huddleston*, 640 F.2d at 549).

41. *Semerenko v. Cendant Corp.*, 223 F.3d 165, 184–85 (3d Cir. 2000).

42. *Id.* (citing Judge Sneed’s concurring opinion in *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345 (9th Cir. 1976), as “stating that an investor’s proximate losses are limited to those amounts that are attributable to the unrecovered inflation in the purchase price”).

43. *Id.*

44. *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003).



a fraudulently concealed risk, it observed, easily satisfies the requirement of showing loss causation.<sup>45</sup>

### B. Pleading Standards under the PSLRA

Generally speaking, the Federal Rules of Civil Procedure call for a liberal standard of notice pleading—allowing plaintiffs to proceed with their claims if they provide the defendants with fair notice of the nature of their case.<sup>46</sup> Federal Rule of Civil Procedure 9(b), which requires the “circumstances constituting fraud or mistake shall be stated with particularity,” demands something more than simple notice pleading; but its scope is limited, and its application to securities cases gave rise to conflicting standards that Congress sought to resolve when it enacted the PSLRA, adding § 21D to the Securities Exchange Act.<sup>47</sup>

Subsections (b)(1) and (2) of § 21D set forth uniform and stringent standards for pleading securities-fraud claims—requiring investors both to specify in their complaints just what was misleading and the reasons why,<sup>48</sup> and to plead facts raising “a strong inference that the defendant acted with the required state of mind” whenever scienter is an element of liability.<sup>49</sup> These provisions were designed to resolve conflicts

45. *Id.* (noting as satisfactory “a causal connection between the concealed information—*i.e.*, the executive’s history—and the ultimate failure of the venture”).

46. See FED. R. CIV. P. 8(a)(2) (requiring a “short and plain statement of the claim showing that the pleader is entitled to relief”); FED. R. CIV. P. 8(e) (“No technical forms of pleading or motions are required.”); *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 513–15 (2002) (applying liberal notice pleading standards); *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 167–68 (1993) (reaffirming its notice pleading standard as explained in *Conley v. Gibson*, 355 U.S. 41 (1957)); *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974) (stating that it “is well established that, in passing on a motion to dismiss . . . for failure to state a cause of action, the allegations of the complaint should be construed favorably to the pleader”); *Conley v. Gibson*, 355 U.S. 41, 47 (1957) (stating “the Federal Rules of Civil Procedure do not require a claimant to set out in detail the facts upon which he bases his claim”).

47. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995). The PSLRA enacted sweeping changes to the rules governing federal securities actions, of which the new § 21D was but a small part.

48. Section 21D(b)(1) provides:

*Misleading Statements and Omissions.*—In any private action arising under this chapter in which the plaintiff alleges that the defendant –

(A) made an untrue statement of a material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1) (2000).

49. Section 21D(b)(2) provides:

among the circuits and to strengthen the pleading standards for pleading fraud in federal securities-fraud cases—ensuring that investors can identify false or misleading statements and facts raising a strong inference of scienter to lodge allegations of fraud.<sup>50</sup> These provisions do not, by their terms, address the pleading standard required to establish the element of loss causation. However, loss causation is addressed in a later provision, subsection (b)(4), which provides that if a complaint survives the hurdles raised by the PSLRA's pleading requirements,<sup>51</sup> the plaintiffs will ultimately be required to prove loss causation.<sup>52</sup> Therefore, since subsections (b)(1) and (b)(2) impose heightened pleading standards only for pleading falsity and scienter, and subsection (b)(4) addresses loss causation only after the heightened

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*Required State of Mind.*— In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2) (2000).

50. See H.R. CONF. REP. NO. 104-369, at 41 (1995), as reprinted in 1995 U.S.C.C.A.N. 730, 740 (noting that “the courts of appeals have interpreted Rule 9(b)’s requirements in conflicting ways, creating distinctly different standards among the circuits,” and citing “testimony on the need to establish uniform and more stringent pleading requirements”); see also William S. Lerach & Eric Alan Isaacson, *Pleading Scienter Under Section 21D(b)(2) of the Securities Exchange Act of 1934: Motive, Opportunity, Recklessness, and the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 893, 941–42 (1996) (noting SEC Chairman Arthur Levitt’s call on Congress to resolve a split among the circuits in pleading scienter).

51. Section (b)(3) provides for dismissal of complaints that do not meet the preceding pleading requirements. 15 U.S.C. § 78u-4(b)(3) (2000).

52. The statute states:

Loss Causation.— In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages.

15 U.S.C. § 78u-4(b)(4) (2000). Ironically, the provision’s legislative history strongly suggests that Congress sought to codify something like the Ninth Circuit rule that loss consists of paying an inflated price for a security. The Senate Report characterized the provision as one “codifying the requirement under current law that plaintiffs prove that the loss in the value of their stock was caused by the § 10(b) violation and not by other factors,” explaining that it

[r]equires the plaintiff to show that the misstatement or [omission] alleged in the complaint caused the loss incurred by the plaintiff. For 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 or omission.

S. REP. NO. 104-98 at 7, 15 (1994), as reprinted in 1995 U.S.C.C.A.N. 679. The Statement of the Managers accompanying the Conference Report explained that the new legislation

[r]equires the plaintiff to plead and then to prove that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff in new § 21D(b)(4) of the 1934 Act. For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.

H.R. CONF. REP. NO. 104-369, at 41.

pleading standards have been cleared,<sup>53</sup> it is a fair inference that the section leaves loss causation subject to ordinary notice-pleading standards.

### III. THE SUPREME COURT'S *DURA* DECISION

#### A. *Facts and Procedural History*

*Dura* arose as a securities class action filed in the United States District Court for the Southern District of California, on behalf of investors who purchased Dura Pharmaceuticals securities between April 15, 1997, and February 24, 1998 (Class Period), against Dura Corporation itself and several of its top officers (collectively “Dura”).<sup>54</sup>

The plaintiff investors alleged that Dura made misleading statements to securities analysts and investors on two subjects: (1) sales of Dura’s “Ceclor CD” antibiotic product, and (2) the status of its new “Albuterol Spiros” (AlSpiros) device for delivering Albuterol asthma medicine.<sup>55</sup> Defendants’ misstatements, the plaintiff investors contended, inflated the price of Dura securities through the Class Period (and after), causing them to overpay when they purchased those securities.<sup>56</sup> Their Second Amended Complaint detailed how Dura falsely represented that Ceclor CD antibiotic sales were increasing—when in truth, Dura knew they were dropping.<sup>57</sup>

The plaintiffs also claimed that Dura falsely represented that completed tests showed its new AlSpiros drug-delivery system, designed to aerosolize a powdered form of the asthma drug Albuterol so that it could be inhaled easily, was effective and poised for Food &

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53. 15 U.S.C. § 78u-4(b)(3) (2000).

54. J.A. at 34a, *et seq.*, *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627 (2005) (No. 03-932); *see* J.A. at 59a-60a (showing lead plaintiffs’ individual purchases), J.A. at 60a-63a (listing defendants); J.A. at 138a-39a (stating class allegations).

55. J.A., *supra* note 54, at 34a-58a.

56. J.A., *supra* note 54, at 55a, 58a, 139a.

57. J.A., *supra* note 54, at 48a-52a. Specifically, Ceclor CD sales began to drop around March and April 1997 (from 47,288 units in March to 39,808 in May), and ultimately dropped nearly 50% by midsummer (24,797 units in July). J.A., *supra* note 54, at 70a-71a. As Ceclor CD sales collapsed, Dura publicly asserted that they were strong, falsely reporting increased market share by comparing Ceclor CD, not to the entire class of respiratory antibiotics, but to generic Ceclor products. J.A., *supra* note 54, at 49a. By late 1997, the investors asserted, Dura’s channels were jammed with many months of unsold inventory, versus the normal one-month supply. J.A., *supra* note 54, at 50a, 110a. In December of 1997 Dura began to offer a 5% price reduction to wholesalers, trying to get them to take even more. J.A., *supra* note 54, at 49a-50a. Not until early 1998 did Dura belatedly admit to the drop-off in Ceclor CD sales, the clogged sales channels, and the need to hire hundreds of additional sales personnel to move the product and salvage Ceclor CD sales. J.A., *supra* note 54, at 51a, 109a-10a.

Drug Administration (FDA) approval.<sup>58</sup> In truth, the investors said, clinical trials and in-house testing had shown that the device was fatally flawed—it rarely worked properly.<sup>59</sup> Dura's top engineers recommended that Dura not proceed with scheduled Phase III clinical trials, let alone file a New Drug Application (NDA) with the FDA, until the known reliability and stability problems were resolved.<sup>60</sup> But Dura's top executives ignored their warnings.<sup>61</sup> During its clinical trials AlSpiros experienced a failure rate exceeding 30%, versus an industry target of less than 1%.<sup>62</sup>

Dura nonetheless told the investing public that it was successfully executing on its AlSpiros drug-delivery technology, and was pleased with the results.<sup>63</sup> This, the plaintiff investors insisted, was false.<sup>64</sup> Even following the disastrous Phase III clinical trials—in which the product had to be modified several times—Dura never managed to solve the product's stability problems and eventually had to abandon AlSpiros.<sup>65</sup>

Why the alleged misrepresentations? Dura's original business strategy had been to sell niche-market pharmaceutical drugs.<sup>66</sup> By 1995, seeing that it would be increasingly difficult to sustain revenue and earnings-per-share (EPS) growth solely by securing rights to market niche drugs, management decided to change course.<sup>67</sup> Dura would become a *medical-device* company, developing and marketing its own proprietary products.<sup>68</sup> Because this metamorphosis would cost millions of dollars—and to avoid a huge negative impact on its reported earnings—Dura's management created Spiros Development Corp. (Spiros I) in December 1995, to incur Dura's costs of developing the

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58. J.A., *supra* note 54, at 35a, 76a–78a.

59. J.A., *supra* note 54, at 37a–43a, 45a–47a, 51a–53a.

60. J.A., *supra* note 54, at 37a–38a; 40a.

61. J.A., *supra* note 54, at 40a, 74a. In October 1996, Dura's Vice President of Product Development, Robert Eisele, authored an internal report (the "Eisele List") examining and explaining the existing problems with the AlSpiros product. AlSpiros, the report noted, was incapable of consistently delivering the required drug dosage or of withstanding normal use conditions, and its cassette system suffered from instability. J.A., *supra* note 54, at 37a–39a. These problems persisted throughout the Phase III final clinical trials despite several modifications, producing a 30% overall failure rate during the trials. J.A., *supra* note 54, at 39a–43a.

62. J.A., *supra* note 54, at 40a–41a, 73a.

63. J.A., *supra* note 54, at 45a, 66a–67a.

64. J.A., *supra* note 54, at 72a–74a.

65. J.A., *supra* note 54, at 41a–43a, 53a.

66. J.A., *supra* note 54, at 34a–35a.

67. J.A., *supra* note 54, at 34a–35a.

68. J.A., *supra* note 54, at 34a–35a.

Spiros drug-delivery system.<sup>69</sup>

By the spring of 1997 the securities market clearly understood that AlSpiros was critical to Dura's future.<sup>70</sup> Without AlSpiros, said securities analysts, Dura would be "strictly" a specialty-drug marketing company, limited to selling "niche respiratory product lines."<sup>71</sup> AlSpiros was what "differentiates Dura," because it would "provide an important growth catalyst" and add an anticipated \$58 million to Dura's sales in 1999, and then \$100 million in 2000.<sup>72</sup>

So, starting in April 1997 through December 1997 defendants began to crow about Ceclor CD sales and AlSpiros—stating that Ceclor CD sales were strong and gaining market share, and that AlSpiros was a "durable" product that worked and was efficacious.<sup>73</sup> As a consequence, Dura's stock rose from \$27-7/8 in April to \$44-7/8 share by mid-July 1997.<sup>74</sup> Taking advantage of the inflated price, Dura on July 25, 1997, accomplished a \$287.5 million convertible-note offering—its largest securities offering ever.<sup>75</sup> At the same time, Dura insiders unloaded nearly 190,000 of their own common-stock shares for \$7 million in proceeds.<sup>76</sup>

Throughout the fall of 1997, Dura trumpeted Ceclor CD sales, and stated that AlSpiros development was on track for commercial sales beginning in 1998.<sup>77</sup> As a consequence, Dura's stock price climbed still further, to \$52-1/4 on October 8, 1997—an all-time high.<sup>78</sup> Two days later, Dura announced it was going to exercise its option to buy Spiros I's stock using Dura stock, and would launch a successor company—Spiros II—via a sale of units to the public that would include warrants to buy the high-flying Dura stock.<sup>79</sup> Within a few days, on October 14, 1997, Dura reported record earnings attributing ostensibly strong pharmaceutical-sales growth to several factors, including excellent Ceclor CD sales.<sup>80</sup> With Dura's stock price high, individual defendants

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69. J.A., *supra* note 54, at 36a, 44a.

70. J.A., *supra* note 54, at 76a–78a.

71. J.A., *supra* note 54, at 76a–77a.

72. J.A., *supra* note 54, at 76a–78a.

73. J.A., *supra* note 54, at 65a–67a.

74. J.A., *supra* note 54, at 45a, 67a, 81a.

75. J.A., *supra* note 54, at 92a. Two lead plaintiffs purchased 65 of those notes, at over \$1,000 apiece. J.A., *supra* note 54, at 60a.

76. J.A., *supra* note 54, at 120a–22a.

77. J.A., *supra* note 54, at 92a–96a, 101a–03a.

78. J.A., *supra* note 54, at 94a.

79. J.A., *supra* note 54, at 94a.

80. J.A., *supra* note 54, at 95a–96a.

again sold personal stock holdings, collecting another \$9.2 million.<sup>81</sup> And on December 17, 1997, Dura and Spiros II successfully completed the Spiros II offering, selling 5.5 million Spiros II units (at \$16 each) for \$88 million.<sup>82</sup>

On February 24, 1998, within weeks of the offerings and insiders' sales, Dura shocked investors by admitting that Ceclor CD sales were far weaker than previously represented, and that trying to boost sales would require expanding its sales force by 66%, at great expense.<sup>83</sup> Dura's stock price dropped 47% in a day, from a high of \$39-1/8 on February 24 to a low of \$20-3/4 on February 25, on an unprecedented 32-million share trading volume.<sup>84</sup> The stock tumbled another 40% in the ensuing months.<sup>85</sup>

In early November 1998, in a press release that misleadingly downplayed the ruling's significance, Dura revealed that the FDA had rejected its AlSpiros NDA.<sup>86</sup> Although Dura's stock dropped another 20%, then recovered,<sup>87</sup> the investors—who were proceeding under Ninth Circuit law—made no effort to tie this, or any other decline in price, to disclosures concerning AlSpiros. When the FDA issued a “notice of violation” to Dura three days later, charging that the company's press release itself had “misleadingly minimize[d] the fact that Dura must conduct a completely new clinical data [study],” Dura quietly removed the misleading press release from its website.<sup>88</sup>

Notably, the FDA denied Dura's application for the very reasons that an internal Dura document (the Eisele List) had catalogued *before* the Class Period in October 1996, showing that the device was neither reliable nor stable.<sup>89</sup> These were the very reasons for which Dura's

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81. J.A., *supra* note 54, at 105a, 120a–22a. Former FDA employee Prettyman, head of Dura's Regulatory Affairs Department, argued against submitting the AlSpiros NDA to the FDA, but when overruled he sold 15,000 shares at \$48-1/2 for over \$728,000 on November 5—just five days before his department filed it. J.A., *supra* note 54, at 103a, 105a.

82. J.A., *supra* note 54, at 103a.

83. J.A., *supra* note 54, at 51a, 109a–10a.

84. J.A., *supra* note 54, at 51a.

85. See J.A., *supra* note 54, at 110a, 54a (showing stock chart); “Dura Warns On Profit, Teams Up With Lilly On Insulin,” *Bloomberg News*, Sept. 23, 1998 (reporting on Dura's activities).

86. J.A., *supra* note 54, at 110a–11a.

87. See J.A., *supra* note 54, at 156a (charting Dura's closing price and trade volumes).

88. J.A., *supra* note 54, at 111a; Letter From Joan Hankin, Regulatory Review Officer for the U.S. Food and Drug Administration, to Katherine Hefferman, Senior Manager of the Regulatory Affairs Department at Dura Pharmaceuticals Inc. (Nov. 6, 1998), available at <http://www.fda.gov/cder/warn/nov98/7258.pdf>.

89. J.A., *supra* note 54, at 110a–11a.

engineers had advised management not to proceed.<sup>90</sup> Those defects were allegedly so severe that Dura ultimately abandoned its attempts to develop the AlSpiros system—it was never proved to be reliable or efficacious.<sup>91</sup>

Investors who had purchased Dura securities at inflated prices filed suit on January 27, 1999, alleging securities fraud and proposing a Class Period that closed with Dura's first negative revelation centering on Ceclor CD and that, as noted, made little effort to tie Dura's dramatically declining stock price, to investors' evaluation of the AlSpiros device. Following amendments the district court dismissed plaintiffs' Second Consolidated Amended Complaint with prejudice and entered judgment, holding that plaintiffs had not pleaded facts raising a strong inference of scienter regarding false statements about Ceclor CD.<sup>92</sup> The court further held that because Dura had not mentioned the AlSpiros device in the press release about poor Ceclor CD sales, on which Dura stock dropped 47% at the Class Period's close, plaintiffs had not sufficiently pleaded that false statements about AlSpiros had caused them any loss, despite further declines in Dura's stock price.<sup>93</sup>

Plaintiffs appealed, arguing that the district court had erred in ruling that they could neither plead scienter as to statements about Ceclor CD sales, nor loss causation as to the false AlSpiros statements, and the Ninth Circuit reversed.<sup>94</sup> As to Ceclor CD, the Ninth Circuit found that the district court had erred in considering the allegations separately rather than as a whole. It directed the district court to consider allegations about Ceclor CD's market share, strength of sales, channel stuffing, and insider sales, as well as any additional allegations from confidential witnesses about manipulating analysts and a defendant's oft-stated phrase "let 'em catch us," in conjunction with one another to evaluate whether plaintiffs had pleaded facts raising a strong inference of scienter.<sup>95</sup> As to AlSpiros, the Ninth Circuit followed decades of precedent to hold that loss causation does not in every case require "a disclosure and subsequent drop in the market price of the stock . . . because the injury occurs at the time of the transaction."<sup>96</sup> "It is at this

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90. J.A., *supra* note 54, at 37a–39a, 40a, 74a.

91. J.A., *supra* note 54, at 53a, 111a.

92. Pet. for a Writ of Cert., App. at 45a–47a, *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627 (2005) (No. 03-932).

93. Pet. for a Writ of Cert., App., *supra* note 92, at 34a–40a.

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

95. *Id.* at 939–41.

96. *Id.* at 938.

time that damages are to be measured.”<sup>97</sup> Finally, the Ninth Circuit could find no reason to limit any amendment to the Ceclor CD allegations.<sup>98</sup>

### B. Holding

A careful reading of the Supreme Court’s *Dura* decision reveals that the opinion consists of two main sections that deal with matters of “proof” and “pleading” respectively.<sup>99</sup> This Section examines each in turn.<sup>100</sup>

#### 1. *Dura*’s Proof Requirements

The first section of the opinion deals with what securities-fraud plaintiffs ultimately must prove in order to establish loss causation, concluding “that a plaintiff must prove that the defendant’s misrepresentation (or other fraudulent conduct) proximately caused the plaintiff’s economic loss.”<sup>101</sup> While this proof may take a variety of forms, the Supreme Court declined to define either its substantive or temporal parameters with much precision. Instead, the Court held that plaintiffs may prove they suffered economic loss as the “relevant truth beg[an] to leak out” or as “the truth ma[de] its way into the market place.”<sup>102</sup>

In so holding, the Supreme Court declined *Dura* Pharmaceuticals’ request for a rule that would have required a plaintiff to show that a stock drop was directly tied to a corrective disclosure in order to recover.<sup>103</sup> Instead, the Court seemed to recognize that fraud-induced inflation could be removed in any number of ways in addition to a corrective disclosure.<sup>104</sup> According to the Solicitor General, inflation

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97. *Id.*

98. *Id.* at 941.

99. *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631, 1634 (2005).

100. See *infra* Part III.B.1-2 (discussing what plaintiffs must prove in securities-fraud cases to establish loss causation and providing guidance regarding pleading requirements).

101. *Dura*, 125 S. Ct. at 1629.

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

103. See *infra* Part III.C.2 (discussing *Dura*’s position on pleading requirements).

104. Transcript of Record at 38-39, *Dura*, 125 S. Ct. 1627 (No. 03-932) [hereinafter Transcript]. Justice Breyer, at oral argument, noted that inflation might come out in many different ways, not simply an announcement “I’m a liar.” *Id.* According to Justice Breyer, inflation could “ooze out as earning reports come in, but it has to come out.” *Id.* Even the Solicitor General recognized “fraud can be revealed by means other than a corrective disclosure and a drop in the stock price may not be a necessary condition for establishing loss causation in every fraud-on-the-market case.” Brief for the United States as Amici Curiae Supporting Petitioners at 19, *Dura*, 125 S. Ct. 1627 (No. 03-932) [hereinafter U.S. Brief]. The Supreme Court nowhere requires there be a corrective disclosure tied to a stock drop; instead, the Court



attributable to a misrepresentation might be reduced or eliminated even if there were a net *increase* in price.”<sup>105</sup> Although *Dura Pharmaceuticals* and its numerous amici in the securities and business arenas urged stringent rules that would have required proof of a *direct* tie between a previous misrepresentation and any subsequent stock decline, the Supreme Court expressly declined to go that far. Instead, the Court held that “[w]e need not, and do not, consider other proximate cause or loss-related questions.”<sup>106</sup>

## 2. *Dura*'s Pleading Requirements: PSLRA's Procedure Truly Counts

The next section of the *Dura* opinion contains core guidance regarding the loss-causation pleading requirements and confirms that securities-fraud plaintiffs face no enhanced burdens in satisfactorily alleging loss causation.<sup>107</sup> The underlying case was at the motion-to-dismiss stage and the Court was aware that the Ninth Circuit had already granted plaintiffs leave to amend their complaint.<sup>108</sup> The Court declined to adopt the Solicitor General's argument that the Federal Rule's particularity requirements applied to the elements of causation and economic loss and that the PSLRA had raised the pleading standards as to these elements.<sup>109</sup> Rather, to successfully plead loss

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speaks in terms of when “the relevant truth begins to leak out.” *Dura*, 125 S. Ct. at 1631.

105. U.S. Brief, *supra* note 104, at 19–20. The Solicitor General stated that this could occur “if the company corrected the false information and at the same time issued unrelated positive information.” *Id.* And the Supreme Court's opinion acknowledges the possibility of “a claim that a share's higher price is lower than it would otherwise have been—a claim we do not consider here.” *Dura*, 125 S. Ct. at 1632.

106. *Dura*, 125 S. Ct. at 1633–34. See also John C. Coffee, Jr., *Causation By Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse* Broudo, 60 BUS. L. J. 533 (2005) (arguing against loss causation as a basis for securities fraud decisions). This article, written prior to the Supreme Court's ruling in *Dura*, derided the Ninth Circuit's “loss causation” decision. Professor Coffee joined *Dura Pharmaceuticals* and its amici in urging the Supreme Court not only to reverse the Ninth Circuit, but to adopt the “stock drop” rule. *Dura Pharmaceuticals* cited the article in a supplemental pleading accepted by the Supreme Court just weeks before the Court's decision. Thus, all of Professor Coffee's views, as expressed in the article, were before the Court when it made its decision.

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

108. Plaintiffs' counsel Patrick Coughlin reminded the Supreme Court that the Ninth Circuit had already granted leave to amend, and explained that plaintiffs could add more facts explaining how *Dura Pharmaceuticals*' AlSpiros misstatements caused plaintiffs' losses. Transcript, *supra* note 104, at 43. The Supreme Court remanded the case to the Ninth Circuit “for further proceedings consistent with this opinion.” *Dura*, 125 S. Ct. at 1628. The Ninth Circuit then remanded with directions that the plaintiffs be permitted to replead their claims in light of the Supreme Court's rulings. *Broudo v. Dura Pharm., Inc.*, No. 01-57136 (9th Cir. June 27, 2005) (“On remand, plaintiffs-appellants shall be afforded an opportunity to amend their complaint, *inter alia*, in a manner that complies with *Broudo*'s requirements for loss-causation.”).

109. See *Dura*, 125 S. Ct. at 1636–37 (noting that both the Solicitor General and *Dura Pharmaceuticals* had argued that loss-causation allegations must be stated with particularity under

causation in a securities-fraud action, plaintiffs simply need to allege a “short and plain statement” of the loss and how defendants caused it, sufficient to provide defendants with “fair notice[.]”<sup>110</sup> This should not be difficult, the Court explained, because satisfactory loss-causation allegations need only “provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.”<sup>111</sup>

Clearly, the Court means for this pleading exercise to be a fairly simple one focused on the plaintiff’s subjective belief of how the defendant caused the loss.<sup>112</sup> Twice, in fact, the Supreme Court explains that the plaintiff needs only to allege an “indication” of the economic loss and proximate cause that “*the plaintiff has in mind.*”<sup>113</sup> This language, considered in conjunction with the Court’s acknowledgment that a “tangle of factors” related to price will have to be sorted out at the proof stage,<sup>114</sup> makes clear that the Court does not intend for the motion-to-dismiss stage to become a mini-trial on loss-causation scenarios.

Professor Coffee, in analyzing the loss-causation question presented to the Supreme Court, has noted the truism that “procedure counts.”<sup>115</sup> If procedure counts, courts should not make case-dispositive loss-causation determinations at the pleading stage simply because the case does not involve a final, dramatic disclosure that causes a stock price to plummet. Further, the PSLRA specifically allows plaintiffs to plead loss causation without specificity.<sup>116</sup> In *Dura*, the Supreme Court

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Federal Rule of Civil Procedure 9(b)); see also U.S. Brief, *supra* note 104 at 15 (arguing that to establish loss causation in a fraud-on-the-market case, a plaintiff must plead and prove that the inflation in the price of the security attributable to the misrepresentation was eliminated or reduced); Reply Brief of Petitioners at 10-11, *Dura*, 125 S. Ct. 1627 (No. 03-932) [hereinafter *Dura* Reply Brief] (arguing respondent’s attempts to distinguish the burden of “pleading” and “proof” under the PSLRA are disingenuous); *Dura*, 125 S. Ct. at 1636 (noting that the Solicitor General also argued that loss-causation allegations must satisfy the heightened pleading requirements of the PSLRA); Transcript, *supra* note 104, at 20 (expressing skepticism of the Solicitor General’s heightened pleading requirements). The Supreme Court ultimately did not impose the heightened pleading requirements *Dura* Pharmaceuticals and the Solicitor General requested for the elements of causation and economic loss. *Dura*, 125 S. Ct. at 1634.

110. See *Dura*, 125 S. Ct. at 1634 (stating that “fair notice” requires the plaintiff to identify his claim and the grounds upon which it rests).

111. *Id.*

112. *Id.*

113. *Id.* (emphasis added).

114. *Id.* at 1632.

115. Coffee, *supra* note 106, at 539, 547. Throughout his article, Professor Coffee takes issue with the loss-causation approach suggested in a companion *Business Lawyer* article written by his Columbia Law School colleague Professor Merritt Fox. Coffee, *supra* note 106, at 533-48. Professor Coffee says that the differences between him and Professor Fox may “well boil down . . . to my insistence that *procedure counts.*” *Id.* at 539 (emphasis in original). And again, in his conclusion: “Procedure counts.” *Id.* at 547. See also Fox, *supra* note 6, at 507.

116. See *supra* notes 48-53 and accompanying text (describing the PSLRA’s provisions).

appears to agree.<sup>117</sup>

Procedurally, the PSLRA only requires that plaintiffs ultimately prove loss causation and not that they plead it with unshakeable specificity. Section 21D(b)'s statutory text, on its face, imposes particularized pleading requirements for falsity and scienter allegations.<sup>118</sup> First, "*the complaint shall specify* each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, *the complaint shall state* with particularity all facts on which that belief is formed."<sup>119</sup>

Second, with respect to fraudulent intent, Congress again specified that, "*the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity* facts giving rise to a strong inference that the defendant acted with the required state of mind."<sup>120</sup> The Ninth Circuit recognizes that "[t]his is not an easy standard to comply with—it was not intended to be—and plaintiffs must be held to it."<sup>121</sup> Further, subsection (b)(3) commands that "the court shall, on the motion of any defendant, dismiss the complaint if the [falsity and scienter] requirements . . . are not met."<sup>122</sup>

The statute never calls for dismissal, however, if plaintiffs fail to plead loss causation with particularity.<sup>123</sup> To the contrary, when the

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117. *Dura*, 125 S. Ct. at 1634. In *Dura*, the Court held that plaintiffs satisfy the *pleading* of loss causation with nothing more than a "short and plain statement" of the loss sufficient to provide defendants "fair notice." *Id.* (citing *Conley v. Gibson*, 355 U.S. 41, 47 (1957)). The statement need only "provide a defendant with *some* indication of the loss and the causal connection that the plaintiff *has in mind*." *Id.* (emphasis added); see also *infra* notes 139–40 and accompanying text (stating that *Dura* reaffirms the previous decision in *Conley* that to show loss causation the pleading need only contain a "short and plain statement").

118. See 15 U.S.C. § 78u-4(b)(1) to 4(b)(2) (2000) (stating "the complaint shall specify each statement alleged to have been misleading, the reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed"); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 830 n.3 (noting Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 21D(b), 109 Stat. 737 (1995)).

119. 15 U.S.C. § 78u-4(b)(1) (emphasis added).

120. 15 U.S.C. § 78u-4(b)(2) (emphasis added).

121. *Eminence Capital, L.L.C. v. Aspeon, Inc.*, 316 F.3d 1048, 1052 (9th Cir. 2003). In the joint House-Senate Conference Report that accompanied the PSLRA, Congress noted the "need to establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits," and so intended the PSLRA "to strengthen existing pleading requirements." H.R. CONF. REP. NO. 104-369, at 41, as reprinted in 1995 U.S.C.C.A.N. 730, 740 (1995).

122. 15 U.S.C. § 78u-4(b)(3)(a). The Solicitor General had tried to assert that the heightened pleading requirements of paragraphs (1) and (2) should apply to loss causation. U.S. Brief, *supra* note 104, at 15. The Supreme Court declined to adopt this position. *Dura*, 125 S. Ct. at 1634.

123. Thus, loss causation is subject to ordinary notice pleading rules, so that "[a]t the pleading stage, general factual allegations of injury resulting from the defendant's conduct may suffice, for

complaint survives a motion challenging the pleadings, the statute specifies that the plaintiff then “shall have *the burden of proving* that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.”<sup>124</sup> Congress did not detail how this proof must ultimately be presented, let alone command that it must be adduced with specificity at the pleading stage.<sup>125</sup>

Aside from the PSLRA’s clear text and the Supreme Court’s binding ruling in *Dura*, the realities of pleading also undermine suggestions that loss causation be subjected to a dispositive analysis at a lawsuit’s earliest stages.<sup>126</sup> A complex scheme’s impact on a company’s stock price ordinarily requires expert analysis to eliminate market variables and isolate company-specific information, which may involve an event study with regression analysis, or even discovery,<sup>127</sup> for a full understanding of the scheme, its scope, and duration.<sup>127</sup> With the PSLRA’s automatic stay of discovery until after a determination of the pleadings’ sufficiency,<sup>128</sup> such a full analysis may simply be impossible to perform at the pleading stage. It is better left for proof, as the statute dictates, at summary judgment or trial. The Supreme Court itself has held that complicated issues like stock valuation and market reactions are better left for trial, to be sorted out by the factfinder.<sup>129</sup> The Court reaffirmed that view in *Dura*.<sup>130</sup>

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on a motion to dismiss we presume that general allegations embrace those specific facts that are necessary to support the claim.” *NOW v. Scheidler*, 510 U.S. 249, 256 (1994) (quoting *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 561 (1992)); *compare* FED. R. CIV. P. 8(a) (defining the standard pleading requirements) *with* FED. R. CIV. P. 9(b) (defining the heightened pleading standard for cases of fraud).

124. 15 U.S.C. § 78u-4(b)(4) (emphasis added).

125. *See supra*, notes 120–24 and accompanying text (detailing specificity of proof at the pleading stage).

126. *See infra* notes 127–30 (demonstrating the necessity for factfinder review of causation).

127. *See* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 *BUS. L. J.* 1, 18–19 (1982) (discussing finance theory and various market studies).

128. 15 U.S.C. § 78u-4(b)(3)(D).

129. *Basic Inc. v. Levinson*, 485 U.S. 224, 248 n.29 (1988).

[T]here may be a certain incongruity between the assumption that Basic shares are traded on a well-developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements. Proof of that sort is a matter for trial . . . .

*Id.*

130. *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1634–35 (2005).

### C. Arguments Rejected by the *Dura* Court

While the foregoing explains what the Supreme Court's *Dura* opinion holds, the opinion is also notable for what it does *not* hold.<sup>131</sup> *Dura* Pharmaceuticals and its amici tried mightily to convince the Supreme Court to raise both the proof and the pleading bars of securities-fraud actions well out of reach of many defrauded investors.<sup>132</sup> A reasoned analysis of the *Dura* opinion shows that their efforts failed.<sup>133</sup>

#### 1. Abandoning the *Basic* Rule

First, *Dura* Pharmaceuticals and commentators like Professor Coffee hoped the Court might reconsider the holding in *Basic Inc. v. Levinson*.<sup>134</sup> *Basic* created a rebuttable presumption of plaintiffs' reliance on the integrity of a security's stated market price. According to Professor Coffee, this presumption could have been significantly curtailed in *Dura*.<sup>135</sup> The Court instead repeatedly cited *Basic* with approval, used *Basic* to lay out a securities-fraud action's basic elements, and reaffirmed the provision of a rebuttable presumption of investors' reliance on a stock's public market price.<sup>136</sup>

#### 2. Requiring that Loss Causation be Pleaded with Specificity

*Dura* Pharmaceuticals and the Solicitor General had urged the Supreme Court to hold that loss causation needed to be pleaded, like falsity and scienter, with Rule 9(b) particularity.<sup>137</sup> The Justices reacted to that argument with skepticism at the January 12, 2005, oral argument, and the Court's opinion does not adopt the argument.<sup>138</sup> In fact, *Dura* reaffirms the vitality of *Conley v. Gibson*<sup>139</sup> and the requirement that,

131. See *infra* Parts III.C.1–3 (discussing the Court's rejection of various arguments brought forth by petitioners).

132. See *infra* Part III.C.2 (discussing *Dura* and its amici's attempt to argue for heightening both the proof and pleading requirements in securities-fraud cases).

133. See *infra* Part III.C.3 (explaining why the Supreme Court in *Dura* rejected *Dura*'s arguments).

134. *Basic Inc. v. Levinson*, 485 U.S. 224, 250 (1988) (holding that it is appropriate to apply a rebuttable presumption of reliance supported by the fraud-on-market theory).

135. Coffee, *supra* note 106, at 544, 546 (arguing for a "stock-drop" rule in place of "loss causation").

136. *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631, 1634 (2005).

137. U.S. Brief, *supra* note 104, at 15; *Dura* Reply Brief, *supra* note 109, at 11.

138. Justice Ginsburg, for example, specifically stated to the government during oral argument, "I thought you pointed to the 9(b) rule because fraud must be pleaded with particularity, but causation does not, not under the rules and not under the statute." Transcript, *supra* note 104, at 20.

139. *Conley v. Gibson*, 355 U.S. 41, 47 (1957) (holding that the Federal Rules of Civil

absent special pleading rules, a complaint need only provide a “short and plain statement” of loss causation.<sup>140</sup> “[I]t should not prove burdensome,” explained the Court, “for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.”<sup>141</sup> That explanation is consistent with the Court’s earlier observation that the “tangle of factors affecting price” will be part of the *proof* of loss causation<sup>142</sup> and a fact-intensive inquiry clearly reserved for trial.

### 3. Requiring a Direct Link Between A Corrective Disclosure and A Stock Price Drop

Next, the Court declined to adopt the argument, urged by Dura Pharmaceuticals and its amici, that loss causation requires that there always exist a corrective disclosure specifically linked to a final stock drop.<sup>143</sup> Professor Coffee had asserted that absent a dramatic reaction to a disclosure contradicting the defendants’ earlier representation, loss determinations are necessarily speculative or hypothetical. Instead, the Supreme Court explained in *Dura’s* “proof” discussion that plaintiffs’ economic loss may occur as the “relevant truth begins to leak out,” or as “the truth makes its way into the market place.”<sup>144</sup> Importantly, the Court did not require an explicit corrective *disclosure* as the mechanism

Procedure require only a “short and plain statement of the claim that will give the defendant fair notice of what the plaintiff’s claim is and the grounds upon which it rests”).

140. *Dura*, 125 S. Ct. at 1634 (citation omitted); *see also* U.S. Brief, *supra* note 104, at 15. The Solicitor General also argued that allegations dealing with the element of loss causation “must satisfy the pleading requirements added to the 1934 Act by the PSLRA, see 15 U.S.C. § 78u-4(b)(1) and (2).” U.S. Brief, *supra* note 104, at 15. This argument, as replied to at oral argument by Justice Ginsburg, fared little better than the Solicitor General’s Rule 9(b) contention. Transcript, *supra* note 104, at 20.

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

142. *Id.* at 1632.

143. *Id.* A more pernicious extension of that argument further urged the Court to hold that the final drop in response to such a disclosure should be, in every case, the *total* measure of plaintiffs’ damages. If this argument had been accepted, defendants would be able to use the PSLRA’s 90-day look-back provision (15 U.S.C. § 78u-4(e)(1)), and defendants also would be able to argue that because the stock eventually bounced back above its post-disclosure final drop, plaintiffs suffered *no loss at all* in the case. The “look back provision” requires that:

[T]he award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid . . . by the plaintiff for the subject security and the mean trading price of the security during the ninety-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

15 U.S.C. § 78u-4(e)(1) (2000).

144. *Dura*, 125 S. Ct. at 1631–32. At oral argument, Justice Breyer recognized the truth might come out in “subtle ways as well as direct ways.” Transcript, *supra* note 104, at 55.

by which the truth “leak[ed]” out.<sup>145</sup>

As one of this article’s authors explained at oral argument, there are myriad ways in which the truth involving defendants’ fraud can be communicated to the market, thereby removing inflation from the stock price and harming investors.<sup>146</sup> In fact, the Justices at oral argument recognized that fraud-induced inflation can be removed in a number of ways.<sup>147</sup> The Supreme Court has now confirmed that plaintiffs need only provide defendants with “some indication” of the connection between that leakage and plaintiffs’ claimed economic loss.<sup>148</sup> In requiring a plaintiff to prove economic loss by pointing to factors related to the fraud, the Supreme Court in *Dura* recognized that fraud could cause losses by a variety of means other than explicit corrective disclosures.<sup>149</sup> This Section discusses several alternate means and shows that the Supreme Court correctly rejected *Dura* Pharmaceuticals’ desired rule.

a. Alternate Methods of Correcting Fraud and Determining Loss

i. *Subsequent Price Increases and Manipulated Earnings Projections*

As the Solicitor General asserted in *Dura*, “inflation attributable to a misrepresentation might be reduced or eliminated even if there were a net *increase* in price.”<sup>150</sup> The Solicitor General did not argue that loss causation requires a corrective disclosure—only that “the truth was revealed (at least in part) and the inflation in the price of the security attributable to the misrepresentation was thereby eliminated (or reduced) to the plaintiff’s detriment.”<sup>151</sup> As an example, the Solicitor General found that inflation could be eliminated without a drop in the price—and perhaps even with a rise—if a company were to “correct . . . the false information and at the same time issue . . . unrelated positive information.”<sup>152</sup> The Solicitor General specifically noted that “fraud can be revealed by means other than a corrective disclosure, and a drop in

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

146. Transcript, *supra* note 104, at 33.

147. *Id.*

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

149. See *Infra* Part III.B.1 (discussing losses not caused by corrective disclosures).

150. U.S. Brief, *supra* note 104, at 27. In fact, the Supreme Court acknowledged this scenario, but declined to address it. *Dura*, 125 S. Ct. at 1632.

151. U.S. Brief, *supra* note 104, at 16. The Supreme Court’s opinion speaks in terms of the “relevant truth” reaching the market—not of corrective disclosures tied to stock drops. *Dura*, 125 S. Ct. at 1631. That the inflation only need be “reduced,” according to Professor Coffee, requires very little. Coffee, *supra* note 106, at 550.

152. U.S. Brief, *supra* note 104, at 19–20.

the stock price may not be a necessary condition for establishing loss causation in every fraud-on-the-market case. To the extent that courts or litigants have suggested otherwise, they are mistaken.”<sup>153</sup>

The reasons for this are not complex. Market valuations are based upon expected future cash flows discounted by the cost of capital.<sup>154</sup> These cash flows are commonly referred to as discounted cash flows. Open-market frauds commonly manipulate stock market price increases by artificially raising cash flow expectations. Conversely, cash-flow expectations just as easily can be lowered to reduce fraud-induced inflation without an overt disclosure of the fraud by defendants issuing further statements—true or false—that on their face may or may not appear to be directly related to the original fraud.

For example, a defendant corporation that falsified historical earnings to increase projected cash flow may reduce future cash-flow expectations by either announcing lower-than-expected revenues or earnings, or that it needs to increase its cash reserves for a new product or business initiative. Either of these actions may reduce fraud-based inflation without any “corrective disclosures” bearing a clear relation to the earlier fraud, let alone any dramatic stock drops on disclosures of the fraud. However, each is a revelation of the true financial condition or operations of the company in contrast to earlier misrepresentations. So long as cash-flow expectations purport to provide some indication of the true state of defendant corporations’ operations, however, false statements may be regarded as having caused plaintiffs’ economic loss.<sup>155</sup>

## ii. *Passage of Time*

Even the passage of time will dissipate a major fraud’s impact on a

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153. U.S. Brief, *supra* note 104, at 19.

154. See RICHARD A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 67–72, 78 n.1 (1983) (analyzing common stock valuation and fluctuations with inflation); RICHARD A. BREALEY & STEWART C. MYERS, CAPITAL INVESTMENT AND VALUATION 77 (2003) (demonstrating how to calculate a present value through finance); EUGENE F. FAMA & MERTON H. MILLER, THE THEORY OF FINANCE 87-89 (1972) (outlining various financial cash flows and earnings formulas); Burton G. Malkiel, *Is the Stock Market Efficient?*, 243 SCIENCE 1313, 1316 (1989) (detailing the standard “rational” model of share pricing); Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411, 415–16 (1961) (utilizing the discounted cash flow approach to value shares); see also Jay W. Eisenhofer, Geoffrey C. Jarvis & James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 BUS. LAW. 1419, 1421–24 (2004) (analyzing a stock price as a discounted value of a future cash flow).

155. See *supra* notes 144–45 and accompanying text (explaining how truth makes its way into the marketplace).



stock's price. Inflation from sales or asset overstatements dissipates over time, for instance, as does inflation due to earnings misstatements.<sup>156</sup> This occurs again as a new picture of the company's operations hits the market over time. Because investors rely on recent earnings to project future cash flows, the effect of an earlier overstatement fades with the passage of each subsequent quarter.<sup>157</sup> Justice Breyer suggests that time can make the connection between fraud and loss more attenuated.<sup>158</sup> While time may certainly make it tougher to disentangle other market forces, *et cetera*, this determination should be reserved for experts at the proof stage of the litigation and not the pleading stage.<sup>159</sup>

Thus, truthful disclosure of falsified quarterly earnings that would have been quite material to the market at the time of the earnings announcement may be rendered far less important years later, when more recent quarterly performance information is available that provides a truer picture of the company's operations. But the lack of a visceral, dramatic stock decline accompanying that final disclosure does not mean that the "truth" has not leaked into the market during the

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156. See Marcia Kramer Mayer, Ph.D., Presentation at PLI Securities Litigation & Enforcement Institute 2004: Loss Causation and Damages: Dura and Beyond (Sept. 30, 2004) (stating "inflation declines between purchase and corrective disclosure"); see also *In re* Initial Pub. Offering Sec. Litig., 297 F. Supp. 2d 668, 673 (S.D.N.Y. 2003) (claiming "ordinary market forces affect the rate of artificial inflation" because in some circumstances "the normal functioning of the securities market causes the inflationary effect to dissipate over time"); A. A. Berle, Jr., *Liability for Stock Market Manipulation*, 31 COLUM. L. REV. 264, 269 (1931) (finding that "a false statement . . . some years ago would have little appreciable effect on the price of the stock today").

157. Section 10(b) claims must be filed within five years of the violation, but five years is ens in the stock market.

158. *Dura*, 125 S. Ct. at 1632. "Other things being equal, the longer the time between purchase and sale, the more likely that this is so, *i.e.*, the more likely that other factors caused the loss." *Id.*

159. See, *e.g.*, *id.* (noting, in section of opinion dealing with what plaintiffs must eventually prove, that a "tangle of factors" affects a share's price); see also *Basic Inc. v. Levinson*, 485 U.S. 224, 249 n.29 (1988) (holding that materiality was to be determined on a case by case factual basis).

We note there may be a certain incongruity between the assumption that Basic shares are traded on a well-developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements. Proof of that sort is a matter for trial . . .

*Basic Inc.*, 485 U.S. at 249 n.29; *DeMarco v. Robertson Stephens Inc.*, 318 F. Supp. 2d 110, 124 n.6 (S.D.N.Y. 2004) (stating that actual causes of stock decline "are all matters for the factfinder on a fully-developed record"); *In re* Sears, Roebuck & Co. ERISA Litig., No. 02 C 8324, 32 Empl. Benefits Cas. (BNA) 1699, 2004 U.S. Dist. LEXIS 3241, at \*19 (N.D. Ill. 2004) (explaining that "issues of loss causation are factual matters not proper to resolve on a motion to dismiss").

ensuing years. If plaintiffs can plead and prove that the leakage caused them economic loss, the loss causation element should be satisfied.<sup>160</sup> Recovery should not be denied merely because the defendants managed to conceal their fraud until after the company failed and its stock became worthless.<sup>161</sup>

### iii. Leakage and Market Reactions

Requiring in every case a stock drop following formal disclosure also ignores the fact that our markets are sufficiently efficient to reflect much information *before* its formal announcement. The academic finance literature tells us that securities prices often incorporate new information before it is formally announced.<sup>162</sup> Prices may decline, for example, on rumors of insider trading long before anticipated bad news is formally released and made a matter of public record.<sup>163</sup> Often,

160. *Dura*, 125 S. Ct. at 1633–34.

161. RESTATEMENT (SECOND) OF TORTS § 548A cmt. b (1965). Comment b specifies that far from barring damages, the company's insolvency may in appropriate cases provide the basis for *additional* recovery. Comment b explains that:

[W]hen the financial condition of a corporation is misrepresented and it is subsequently driven into insolvency by reason of the depressed condition of an entire industry, which has no connection with the facts misrepresented, it may still be found that the misrepresentation was a legal cause of the . . . loss, since it may appear that if the company had been in sound condition it would have survived the depression, and hence that a loss of this kind might reasonably have been expected to follow.

*Id.*

162. See, e.g., JAMES H. LORIE, PETER DODD & MARY HAMILTON KIMPTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 100–02 (2d ed. 1985) (citing research indicating that price adjustments occur in advance of formal earnings announcements); BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 185 (6th ed. 1996) (stating “[r]esearch indicates that, on average, stock prices react well in advance of unexpectedly good or unexpectedly bad earnings reports[.]”); WILLIAM F. SHARPE & GORDON J. ALEXANDER, *INVESTMENTS* 522 (4th ed. 1990) (summarizing research showing that “prices of firms that announced unexpectedly low earnings . . . tended to decrease prior to the announcement”); Ray Ball & Philip Brown, *An Empirical Evaluation of Accounting Income Numbers*, 6 J. ACCT. RES. 159, 160–70 & Fig. 1 (1968) (“The information contained in the annual income number is useful if actual income differs from expected income, the market typically has reacted in the same direction.”); Sara Fisher Ellison & Wallace P. Mullin, *Gradual Incorporation of Information Into Stock Prices: Empirical Strategies* 4, 13–14 (National Bureau of Economic Research, Working Paper No. 6218, 1997) available at <http://www.nber.org/papers/w6218> (noting the large body of data showing price effects weeks in advance of major announcements).

163. Ellison, et al., *supra* note 162, at 3–4, 11–17. In *Dirks v. SEC*, 463 U.S. 646 (1983), stock sales by investors with access to adverse inside information regarding a company's accounting improprieties drove its stock from \$26 per share to less than \$15 per share in two weeks—causing the New York Stock Exchange to halt trading—before any public disclosure of the accounting fraud. *Id.* at 649–50, *rev'g Dirks v. SEC*, 681 F.2d 824, 831–32 (D.C. Cir. 1982). In *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974), trading by insiders who knew of undisclosed favorable information “pushed the price of [the] stock by February 18 to nearly three-and-one-half times what it had been at the beginning of the year.” *SEC v. Shapiro*, 494 F.2d 1301, 1307 n.3 (2d Cir. 1974).

disclosures of varying credibility gradually become public throughout a lengthy period, so that the market will not react noticeably at the final disclosure.<sup>164</sup> But under the Supreme Court's analysis, that ultimate *non*-reaction is immaterial, provided the earlier leaks are sufficiently linked to the truth about defendants' operations.<sup>165</sup>

#### *iv. Concealment Issues*

Finally, and perhaps most importantly, Dura Pharmaceuticals' insistence on bald corrective disclosure was impractical because sophisticated individuals who choose to commit market manipulation and fraud are likely to be adept at concealing it, too. Those individuals could reduce or eliminate a disclosure's impact on stock price by downplaying its significance, as Dura Pharmaceuticals did, or by combining it with good news.<sup>166</sup> Having deliberately inflated the stock with myriad misstatements, securities-fraud perpetrators could just as easily "walk down" the stock price by the selective disclosure of seemingly unrelated "bad" news concerning the company and thereby avoid a sudden stock-price reaction, and insulate themselves from liability.<sup>167</sup> Thus, requiring stock drops following explicit corrective disclosures would have empowered the very individuals who committed the original fraud, and perversely encouraged *more* misrepresentations

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164. Cf. *Blackie v. Barrack*, 524 F.2d 891, 909 n.25 (9th Cir. 1975) (holding that "the prolonged nature of the fraud introduces other market variables which may affect the amount the market react[s] to disclosures at different times during the class period").

165. *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1633 (2005).

166. On November 3, 1998, Dura revealed in a press release that the FDA had rejected its AlSpiros new drug application—but minimized the fact that the FDA wanted Dura to "conduct a completely new clinical data [study]." J.A., *supra* note 54, at 110a–11a. The FDA quickly issued a notice of violation to Dura, charging that the company's press release was misleading. Letter from Joan Hankin, Regulatory Review Officer for the U.S. Food and Drug Administration, to Katherine Hefferman, Senior Manager of the Regulatory Affairs Department at Dura Pharmaceuticals Inc., *supra* note 88.

The press release is misleading because through various speculative conclusions, statements, terminology, and overall tone, the release misleadingly suggests that, notwithstanding the submission of some 'additional' information for FDA evaluation, the Agency has reviewed significant clinical evidence for AlSpiros and has determined that the product will be found to be safe and effective for use.

*Id.*; see also *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920 (9th Cir. 2003) (asserting that the disclosed problems would have no financial or operational impact on the company where defendants prevented the "expected" stock drops by issuing positive false statements with each release of the "bad news").

167. The Solicitor General recognized this very point in concluding that a corrective disclosure and a stock drop may not be a necessary condition for establishing loss causation. U.S. Brief, *supra* note 104, at 19. See also *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 966 (7th Cir. 1989) (observing that "a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counterbalancing the loss").

and concealment, not less.

### b. Real-World Examples

Recent real-world events illustrate the problems with focusing exclusively on disclosure-induced stock drops. Our capital markets have been rocked by a series of stunning, multi-billion-dollar frauds in recent years: Enron, WorldCom, and HealthSouth are just three examples.<sup>168</sup> Even today, the full import of these sophisticated frauds are still being sorted out in civil and criminal actions, brought by private litigants, the Securities and Exchange Commission (SEC), and the Department of Justice.<sup>169</sup>

#### i. Enron

In *Enron*, investors were victimized in an especially wide-ranging, long-lasting and diabolically complicated fraud (effectively the largest Ponzi scheme<sup>170</sup> in American corporate history) that caused millions of

168. See *infra* Parts III.C.3.b.i–iii (discussing three examples of disclosure-induced stock drops).

169. In private securities-fraud class action litigation against Enron, for example, the plaintiffs and their attorneys recovered (as of late summer 2005) a record \$7.12 billion from some of the various defendants. Stephen Taub, *Enron Settlements Hit Record \$7 Billion*, CFO.com, Aug. 3, 2005, <http://www.cfo.com/article.cfm/4245836?f=search>. On the criminal side of Enron, former Chief Financial Officer Andrew Fastow pleaded guilty in January 2004 to charges that he helped orchestrate schemes to hide Enron's debt and inflate its profits; he is scheduled to serve a 10-year prison sentence beginning in 2006, after he testifies against Enron president Kenneth Lay and Chief Executive Officer Jeffrey Skilling. *Corporate Scandals*, THE DAILY OKLAHOMAN, June 29, 2005, at 1B. In the WorldCom debacle, former chief executive Bernard Ebbers was sentenced to 25 years in prison in July 2005 "for spearheading the largest accounting fraud in U.S. history." Walter Hamilton, *CEO's Steep Rise, Swift Fall End in 25-Year Prison Term*, L.A. TIMES, July 14, 2005, at A1. Other corporate chieftans are also facing prison time for their roles in recent corporate frauds. See, e.g., Tom Dochat, *Rite Aid's Brown gets fine, 10 years sentence tops those of 5 other executives*, PATRIOT-NEWS (Harrisburg, Pa.), Oct. 15, 2004 at A.01 (reporting former Vice Chairman Franklin C. Brown's 10-year prison sentence is longer than, *inter alia*, the eight-year term handed to Rite Aid's former Chairman and CEO Martin L. Grass and the 28 months being served by Rite Aid's former CFO Frank Bergonzi); Leon Lazaroff, *Ex-chiefs at Tyco get 8-25 years; Kozlowski, Swartz ordered to pay millions in fines, restitution*, BALTIMORE SUN, Sept. 20, 2005, at 1C (reporting that ex-Tyco CEO L. Dennis Kozlowski and former CFO Mark Swartz were both sentenced to 8-to-25-year prison terms, in addition to restitution and fines totaling \$167 million and \$72 million, respectively); *Rigas Father and Son Sentenced to Prison*, MIAMI HERALD, June 21, 2005, at 1C (reporting that Adelphia Communications, Inc. founder John Rigas was sentenced to 15 years, and his ex-finance chief son Timothy was sentenced to 20 years following convictions for "bank fraud . . . securities fraud and conspiracy").

170. "Ponzi scheme" gets its name from a man who used investors' money to float debt.

The term 'Ponzi scheme' is derived from Charles Ponzi, a famous Boston swindler. With a capital of \$150, Ponzi began to borrow money on his own promissory notes at a 50% rate of interest payable in 90 days. Ponzi collected nearly \$10 million in 8 months beginning in 1919, using the funds of new investors to pay off those whose notes had come due.

investors to overpay billions of dollars for Enron's nearly worthless securities at prices as high as \$90 per share.<sup>171</sup> When the scheme finally collapsed and Enron went bankrupt in December 2001, these investors were left holding the bag: their shares of formerly high-flying Enron stock selling for \$0.26 on the last day of trading before the company declared bankruptcy.<sup>172</sup> Those who had orchestrated Enron's sham transactions, including defendant Merrill Lynch, insisted that they could not be liable for any of the investors' losses because the fraudulent nature of many transactions was not fully disclosed until *after* the company declared bankruptcy.<sup>173</sup>

Yet surely those fraudulent transactions contributed to the inflation in Enron's stock price in the heady days before its collapse—inflation that, logically, was removed from Enron's stock price as Enron descended into insolvency and the truth about its operations seeped into the marketplace. As Judge Harmon explained in the *In re Enron Corp.* class action lawsuit, in rejecting Merrill Lynch's argument that it caused no fraud-related losses because its role in Enron's sham transactions was not disclosed until long after Enron stock had already collapsed:

While information about Merrill Lynch's individual role in [the fraud] . . . may not have been made public until long after the Enron bankruptcy, that fact does not relieve Merrill Lynch of responsibility for Enron's collapse; Merrill Lynch's alleged substantial participation in the deceptive business practices contributed to the artificial inflation of the price of the securities and thereby was a direct and major cause of plaintiffs' financial loss . . . .<sup>174</sup>

Thus, investors' "losses" proximately caused by defendants like Merrill Lynch cannot sensibly be limited to the final, post-bankruptcy stock decline of mere pennies.

United States v. Masten, 170 F.3d 790, 797 n.9 (7th Cir. 1999) (citing United States v. Shelton, 669 F.2d 446, 449 (7th Cir. 1982)); see also Alexander v. Compton (*In re Bonham*), 229 F.3d 750, 759 n.1 (9th Cir. 2000) ("Generically, a Ponzi scheme is a phony investment plan in which monies paid by later investors are used to pay artificially high returns to the initial investors, with the goal of attracting more investors."); Cunningham v. Brown, 265 U.S. 1, 7-9 (1924) (detailing Ponzi's fraud scheme).

171. *Enron Declares Bankruptcy; 4,000 Houston Employees Lose Their Jobs*, HOUS. CHRON., Dec. 6, 2001.

172. *Id.*

173. See *In re Enron Corp. Sec.*, 310 F. Supp. 2d 819, 832 (S.D. Tex. 2004) (holding that the timing of the exposure of deceptive business practices that contribute to the artificial inflation of a security does not matter).

174. *In re Enron Corp. Sec.*, 310 F. Supp. 2d at 832. See also Michael L. Cypers, John M. Landry & William H. Forman, *The Future of Loss Causation: Pleading Manipulative and Deceptive Schemes to Avoid Dismissal*, SEC. LITIG. J. (Winter/Spring 2005) (lawyers from Heller Ehrman White & McAuliffe LLP examine scheme liability and conclude it is separate from the narrow issue addressed in *Dura* dealing with misrepresentations or omissions).

*ii. WorldCom*

Similarly, in the WorldCom litigation, certain defendants said that loss causation could not be shown because most of the decline of WorldCom's stock from over \$60 a share to near zero took place before WorldCom's admissions that it had overstated income by \$3.8 billion.<sup>175</sup> Not until months after the bankruptcy did WorldCom admit that the overstatement actually might exceed \$9 billion.<sup>176</sup> And not until March 12, 2004, some 20 months after the bankruptcy, did WorldCom admit that its year 2000 and 2001 financial statements had been misstated by *over \$74 billion*.<sup>177</sup> With WorldCom shares selling for mere pennies by then, the market reaction to an ultimate disclosure simply could not occur.<sup>178</sup> That lack of reaction surely cannot mean that WorldCom investors experienced no loss, however. To the contrary, investors paid not only fraudulently inflated prices for WorldCom securities; the inflation came out as WorldCom stock inexorably declined prior to the March 2004 disclosure on the heels of truthful bad news entering the marketplace about the company's operations.<sup>179</sup>

*iii. HealthSouth*

Finally, in the HealthSouth matter, the sort of stunning disclosures that Professor Coffee would likely say informed the market of fraud—a huge accounting restatement and guilty pleas by company insiders—came seven months after HealthSouth stock had already plummeted.

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175. See Timothy R. Brown, *WorldCom Inc. Says Nearly \$3.8 Billion Hidden In Its Books, CFO Fired*, THE ASSOCIATED PRESS STATE & LOCAL WIRE, June 26, 2002 (explaining that the SEC focused on attempting to return some \$700 million to defrauded investors but limited the relief to those who held WorldCom securities though the June 25, 2002 market close). See Submission of the SEC Addressing the Issues Identified in the Court's May 19, 2003 Order Concerning the Proposed Settlement of the Commission's Monetary Claims Against WorldCom, Appendix, SEC v. WorldCom, Inc., No. 02-CV-4963 (JSR) (S.D.N.Y. June 6, 2003); see also WorldCom Victim Trust Website, <http://www.worldcomvictimtrust.com> (last visited Oct. 24, 2005). Surely the penny-stock speculators to be benefited at this juncture were not the defrauded retirement funds—none of which remained in the stock to the end—that the PSLRA in particular was enacted to protect.

176. *WorldCom to Adjust Errors to \$9 Billion*, L.A. TIMES, Nov. 6, 2002, at C3.

177. Andrew Countryman, *WorldCom Wipes Slate Clean; \$74.4 Billion in Profits Eliminated*, CHI. TRIB., Mar. 13, 2004, at B1; *WorldCom Restates Profits by \$74.4 Billion for 2 Years*, N.Y. TIMES, Mar. 13, 2004, at C14.

178. According to the *Bloomberg L.P.* stock-trading quotes for the days following the \$74.4 billion restatement, WorldCom stock was trading at \$0.23 on the day of its restatement announcement and hovered between just \$0.21-\$0.22 over the next four trading days. (*Bloomberg* printout on file with authors).

179. "By some estimates, WorldCom shareholders lost a collective \$200 billion because of its collapse." Christopher Stern, *Judge Clears WorldCom's Reorganization; Telecommunications Company Will Emerge From Bankruptcy Under MCI Name*, WASH. POST, Nov. 2, 2003, at A04.

On August 27, 2002, HealthSouth reduced its earnings guidance for the year by \$175 million, citing a change in Medicare reimbursement policies,<sup>180</sup> —but that seemingly innocuous disclosure, with no overt reference to the fraud’s minutiae, surely reduced fraud-based inflation by deflating fraud-produced expectations: HealthSouth’s stock price plunged nearly 60% in two days on the bad news, dropping from around \$12 to \$5 per share (a multi-billion-dollar market-cap loss).<sup>181</sup> Some investors filed suit.<sup>182</sup> Not until February 2003, however, did an FBI and Department of Justice criminal investigation become public,<sup>183</sup> followed in March 2003 by the first of over a dozen HealthSouth insiders entering guilty pleas to criminal violations of the securities laws that had contributed to HealthSouth’s overstating some \$2.7 billion in “earnings” from 1996 to 2002.<sup>184</sup>

The market’s reaction to the blockbuster February/March disclosures reduced HealthSouth’s stock from \$3 per share to well under a dollar.<sup>185</sup> This was a visible drop, to be sure, yet far less than the nearly \$7-per-share August 2002 plunge.<sup>186</sup> Under the view of market movement held by Dura Pharmaceuticals and its amici, however, investors’ “loss” could be limited to the stock’s final whimper—not the original 60%, \$7-per-

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180. Mary Haffenberg, *HealthSouth’s Comeback Flames Out*, THESTREET.COM, Aug. 27, 2002, [http://www.thestreet.com/\\_tscs/markets/marketfeatures/10039496.html](http://www.thestreet.com/_tscs/markets/marketfeatures/10039496.html) (“HealthSouth said its annual earnings before interest, taxes, depreciation and amortization will probably fall by \$175 million, making its previous guidance for the current and coming years meaningless.”); *HealthSouth halts guidance*, CNNMoney.com, Aug. 27, 2002, <http://money.cnn.com/2002/08/27/news/companies/healthsouth/index.htm>.

181. Tom Bassing, *Analysts Blast HealthSouth*, BIRMINGHAM BUS. J., Aug. 30, 2002, available at <http://www.bizjournals.com/birmingham/stories/2002/09/02/story1.html> (“By the end of the two-day swoon, HealthSouth’s stock had lost nearly 58 percent of its value, falling from a Tuesday opening price of \$11.97 to Wednesday’s close of \$5.05.”).

182. Tom Bassing, *Scrushy hires Clinton spin doctor*, BIRMINGHAM BUS. J., Sept. 27, 2002, available at <http://www.bizjournals.com/birmingham/stories/2002/09/30/story2.html> (reporting “a slew of investor lawsuits filed against [HealthSouth]”).

183. Milt Freudenheim, *F.B.I. Is Investigating HealthSouth Trades*, N.Y. TIMES, Feb. 7, 2003, at C1.

184. *Ex-CFO Owens Pleads Guilty, Digital Hospital Halted*, BIRMINGHAM BUS. J., Mar. 28, 2003 (HealthSouth chief financial officer William Owens “pleaded guilty in U.S. District Court to charges of wire and securities fraud” while former “CFO Weston Smith last week pleaded guilty to criminal fraud and conspiracy charges”); *HealthSouth CFO to plead guilty; Judge freezes founder’s assets*, CHI. TRIB., Mar. 27, 2003 (Owens’s plea “came a week after former CFO Weston Smith agreed to plead guilty to similar charges”). HealthSouth founder Richard Scrushy fought his criminal charges, however, and was acquitted by a Birmingham, Alabama jury in summer 2005. Jay Reeves, *Scrushy Wins Acquittal, Faces Civil Case*, LEGAL INTELLIGENCER, June 30, 2005, at 4.

185. Roy L. Williams, *Stock Plunge Stings Investors in HealthSouth*, BIRMINGHAM NEWS, Mar. 26, 2003 (reporting HealthSouth shares closed “at 11 cents each” on Tuesday, March 25, 2003).

186. See *supra* note 181 (explaining that HealthSouth stock dropped \$6.92 over two days).

share plunge that we now know with certainty was linked to HealthSouth's financial shenanigans.<sup>187</sup> That view is mistaken, for even if the market's reaction to a fraud's disclosure accurately reflects the importance of information *at the time of that final disclosure*, it says little about the importance of the misstatements in the market at the time of plaintiff's stock purchase.

#### IV. THE FUTURE OF SECURITIES PROOF AND PLEADING AFTER *DURA*

Several commentators, including Professor John Coffee, have attempted to use the *Dura* case as an opportunity to advance their theories regarding restrictions on open-market securities class action suits. In its holding concerning proof and pleading requirements, the Court ultimately rejected their views. Their arguments are ill grounded, and fail to accurately reflect the typical fact pattern underlying open-market securities actions. This Part endeavors to show that such arguments have little basis and should not be followed in future securities actions in light of the *Dura* decision.

##### *A. Investors' Fraud Recoveries Are Not Mere "Wealth Transfers" Between the Corporations' Former and Present Shareholders*

Professor Coffee urges a narrow view of loss causation, apparently assuming that in the "secondary" trading market, at least, securities-fraud lawsuits typically ensnare a corporation that had no motive for fraud.<sup>188</sup> Unless the corporation issued inflated stock in a public offering, it is suggested, a judgment or settlement borne by the corporation (and indirectly, by its current shareholders) is merely a wasteful "wealth transfer" between two classes of shareholders—

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187. See generally *Blackie v. Barrack*, 524 F.2d 891, 909 n.25 (9th Cir. 1975) (rejecting appellant's argument that the loss must be determined by the change in price after a corrective release and holding that such a drop "is of course circumstantial evidence of the inflation when purchased, but it is not the exclusive method of measuring inflation[]"). Other market variables, including the passage of time, or changed conditions and partial disclosures, may affect later market reaction—necessitating expert testimony and the examination of company—specific information to determine the actual inflation on the date of purchase. *Id.* at 906–07 n.22, 909 n.25. Importantly, the Supreme Court declined *Dura Pharmaceuticals'* (and its amici's) invitation to limit recoverable economic loss to any final stock drop. *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1633–34 (2005) ("We need not, and do not, consider other proximate cause or loss-related questions.").

188. Coffee, *supra* note 106, at 541. The so-called "secondary market" includes "exchanges and over-the-counter markets where securities are bought and sold subsequent to original issuance, which took place in the primary market." JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 615 (6th ed. 2003). "Proceeds of secondary market sales accrue to the selling dealers and investors, not to the companies that originally issued the securities." *Id.*



“neither of whom is necessarily culpable.”<sup>189</sup>

Neither thesis is borne out by logic or experience, however. The notion that a corporation should not be liable for its wrongs because its current shareholders are not necessarily culpable is a radical one that, logically extended, would do away with most criminal and civil liability for large companies and would leave them free to run amok. Corporations are legally responsible for the false statements in their press releases and financial filings,<sup>190</sup> as well as for the fraudulent acts of their executives because a corporation can only act through its officers and directors.<sup>191</sup> And, in its most recent comprehensive study of securities class actions, Cornerstone Research’s “2004: A Year in Review” calculates that 79% of *all* securities class action complaints in 2004 contained allegations of misrepresentations in corporations’ financial documents, and nearly 50% alleged violations of Generally Accepted Accounting Principles.<sup>192</sup> Imagine the consequences if corporate defendants who falsified their financial results could avoid liability by showing that shareholders were kept in the dark: their very fraud would become a defense.

The “wealth transfer” suggestion is similarly bereft. Those who subscribe to it<sup>193</sup> appear to be saying that: (1) the shareholders in the class of defrauded stock purchasers are in much the same position as later purchasers; and (2) diversified shareholders are “maximizing” their wealth due to their trading patterns—presumably at the expense of less-diversified investors.<sup>194</sup>

Neither assumption is warranted, for investors are constantly making

189. Coffee, *supra* note 106, at 541.

190. See, e.g., Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (holding, under § 11 of the Securities Act of 1933, liability against a corporation for misstatements in its registration statement “is virtually absolute, even for innocent misstatements”); accord Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 696 (1992) (explaining that “many decisions simply treat the corporation itself as the person uttering the fraudulent statements and hold it liable for false statements made in its name, such as those in required filings with the SEC”).

191. Buxton v. Diversified Resources Corp., 634 F.2d 1313, 1316 (10th Cir. 1980) (by signing audit statements, company president “render[ed] the corporation responsible for the audit statements”); Holmes v. Bateson, 583 F.2d 542, 560 (1st Cir. 1978) (“While a corporation does have an immortal existence, it can conduct its affairs only through its officers and employees.”).

192. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILING 2004: A YEAR IN REVIEW, at 16, (2004), available at [http://securities.stanford.edu/clearinghouse\\_research/2004\\_YIR/2004010305.pdf](http://securities.stanford.edu/clearinghouse_research/2004_YIR/2004010305.pdf) [hereinafter CORNERSTONE RESEARCH].

193. Coffee, *supra* note 106, at 541.

194. This second point Professor Coffee made in more detail at the Institute for Law and Economic Policy conference held on April 7–9, 2005.

investment decisions. Those made *prior* to disclosure of fraud or the truth-reducing expectations reflect one set of variables. Investment decisions made *after* disclosure of the fraud or the truth-reducing expectations, on the other hand, involve different considerations and a lower price.<sup>195</sup> Academic evidence shows that while stock prices generally decline upon the fraud's revelation, there usually are no statistically significant price movements associated with the *resolutions* of securities-fraud cases.<sup>196</sup> Thus, recoveries are not simply a shifting of money from the right to the left pocket even if an investor makes the decision to stay in the stock.<sup>197</sup> The decision to stay is in and of itself a new investment decision, and the new price already reflects the earlier disclosures and the existence of the litigation.<sup>198</sup>

The notion that diversified shareholders are benefited more than other investors by class actions<sup>199</sup> also finds no support. Institutional investors typically make up more than 50% of the shareholder base,<sup>200</sup> and perhaps do recover more, and more often, but most certainly in line with their purchasing (and selling).

Professor Coffee insists both that securities class actions be curtailed because they entail expensive "wealth transfers" and advances another (and apparently inconsistent) argument: that the wealth transfers are trivial.<sup>201</sup> He says recent publications on the recovery rates in securities

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195. *E.g.*, *Harris v. Am. Inv. Co.*, 523 F.2d 220, 228 (8th Cir. 1975) ("By continuing to hold the stock after" the date a securities fraud was disclosed, the investor "has, in effect, made a second investment decision unrelated to his initial decision to purchase the stock."); *Westinghouse Elec. Corp. v. '21' Int'l Holdings, Inc.*, 821 F. Supp. 212, 219–20 (S.D.N.Y. 1993) (concluding that a once defrauded investor who is "on notice of the alleged misstatements" but does not "dispose of its stock or seek rescission" has "made a new investment decision to play the market by retaining" the shares).

196. Stephen P. Ferris & A.C. Pritchard, *Stock Price Reactions to Securities Fraud Class Actions Under the Private Securities Litigation Reform Act*, Paper # 01-009, JOHN M. OLIN CTR. FOR L. & ECON., 36 (Oct. 2001) ("The returns from the date that the decision on the motion to dismiss is announced are not, however, statistically significant.").

197. Coffee, *supra* note 106, at 543. Professor Coffee says "a windfall is awarded to one class of shareholders (typically, the buying shareholders) at the expense of other shareholders." *Id.* Because the price following disclosure reflects the reduced expectations, this is simply not so. And because the statistical evidence demonstrates there is no second drop upon resolution, the recoveries are not at the expense of those that retain or purchase.

198. Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465 (2004). The costs associated with securities class actions are outweighed by the benefits of pursuing such actions in a variety of ways. *Id.* at 1466. First, private enforcement reduces government involvement and costs. Second, class actions help ensure accountability of corporate officers and directors. *Id.* By any measure, reducing the risk of fraud far outweighs any assumed harm to current shareholders.

199. Coffee, *supra* note 106, at 542.

200. *Id.* at 541.

201. *Id.* at 542.

class actions show that recoveries are extremely modest, totaling only 2.7% to 2.8% of investor losses.<sup>202</sup> Ironically, however, these low figures, designed to trivialize securities class actions, come from comparing recovery rates to overall *market* losses and not to losses caused by fraud.<sup>203</sup> This is truly like comparing apples to oranges, for damages due to fraud are often but a fraction of overall market losses.<sup>204</sup> Congress understood this when enacting the PSLRA, noting analysis provided to the Senate Securities Subcommittee which found that, even from a plaintiff's perspective, alleged fraud-related damages in securities litigation typically comprised but 27.7% of overall market losses.<sup>205</sup>

When using an honest comparison of apples to apples, actual recovery rates of fraud-related losses are likely much higher than the 2.7% to 2.8% figures that Professor Coffee proffers. Cornerstone Research calculates that the overall market losses on investments in covered securities, for all cases filed in 2003, were \$542 billion.<sup>206</sup> But no one seriously contends that all—or even most—of that \$542 billion is loss attributable *to fraud*.<sup>207</sup> Using a method commonly employed by defendants that measures potentially recoverable “damages” on the frauds’ final disclosures, Cornerstone calculates fraud-caused losses of \$57.7 billion.<sup>208</sup> This is a figure markedly lower than the 2003 overall market losses of \$542 billion.<sup>209</sup> While recovery of \$15.18 billion in securities-fraud lawsuits amounts to but 2.7%-2.8% of the *overall*

202. *Id.*

203. See Elaine Buckberg, et al., *Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements*, at 8-9 (Feb. 2005), [http://www.nera.com/image/Recent\\_Trends\\_Final\\_2.28.05.pdf](http://www.nera.com/image/Recent_Trends_Final_2.28.05.pdf). The basis for these assertions appears to be the settlement statistics prepared by National Economic Research Associates (NERA). *Id.* at 12. NERA itself acknowledges that the investor losses as calculated are misleading and an exaggerated measure of damages leading to a substantial underestimation of investor recoveries. *Id.* at 8 (“Investor recoveries are frequently—but inaccurately—assessed by comparing settlement values to investor losses.”).

204. *Id.* at 9 (“[C]alculations of the loss attributable to the fraud typically generate numbers substantially lower than investor losses.”).

205. H.R. REP. NO. 104-369, at 42 (Conf. Rep.) (1995), as reprinted in 1995 U.S.C.C.A.N. 730, 741.

206. CORNERSTONE RESEARCH, *supra* note 192, at 2.

207. *Id.* at 10 (listing overall market “Maximum Dollar Loss” of \$542 billion for Year 2003, and comparing to the estimated \$57.7 billion “Disclosure Dollar Loss” that occurred following frauds’ disclosures).

208. See *id.* at 5–10 (discussing methods of calculation).

209. *Id.* at 10. Economic experts often use the price decline following the final disclosures as a basis to measure the inflation in the stock. See *Blackie v. Barrack*, 524 F.2d 891, 909 n.25 (9th Cir. 1995) (stating final “drop is of course circumstantial evidence of the inflation when purchased”).

market losses associated with the securities at issue, when compared with the \$57.7 billion highlighted by Cornerstone as potentially recoverable damages, it yields a much more impressive recovery rate of 26%. In other words, using securities-fraud defendants' own yardstick, the recovery rate is 26% of potentially recoverable damages.

Taking into account that not all investors file claims, of course, the actual recovery for those who do can be significantly higher.<sup>210</sup> In addition, given the increase in dismissals following the PSLRA's passage, the instances where the companies have failed, or where there is no available insurance or viable defendant, recovery rates in securities class actions are substantial, and significant real dollars are recovered by the private class-action mechanism for fraud victims.<sup>211</sup>

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210. See Buckberg, et al., *supra* note 203, at 9 (noting that shareholders who file claims "typically receive twice as much compensation per share" as the aggregate settlement would suggest, because "many shareholders do not file claims").

211. Professor Coffee notes that few securities cases go to trial. Coffee, *supra* note 106, at 537. But if just under 1% of all complex securities cases go to trial, only 1.7% of all federal civil cases, in general, actually reach trial according to the latest federal judicial caseload statistics compiled by the Administrative Office of the United States Courts. See FEDERAL JUDICIAL CASELOAD STATISTICS, Table C-4, <http://www.uscourts.gov/caseload2004/tables/C04Mar04.pdf> (Mar. 31, 2004) (noting percentage of civil actions reaching trial during the 12-month period ending March 31, 2004). If only complex cases were considered, the number likely would be in line with the complex securities class action cases filed and tried.

*B. The Same Facts Can Show Both “Loss Causation” and  
“Transaction Causation.”*<sup>212</sup>

Some commentators seem to suggest that the same *facts* ought never be used to show *both* reliance, or “transaction causation,” and proximate cause, or “loss causation.”<sup>213</sup> This is surely wrong. Nothing in the law requires such mutual exclusivity among the pieces of evidence used to establish elements of a cause of action.<sup>214</sup> For example, in the securities-fraud context, falsity and scienter are often inferred from the same facts.<sup>215</sup> If reliance and proximate cause were both elements of

212. Transaction causation has long gone by the name “reliance.” *See, e.g.,* *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 186 (2d Cir. 2001) (stating that “transaction causation is generally understood as reliance”); *accord* *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 828 (8th Cir. 2003) (comparing transaction causation to reliance); *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 209 (2d Cir. 2000) (analogizing transaction causation to reliance). Loss causation was called “proximate cause.” *In re Daou Sys., Inc., Sec. Litig.*, 397 F.3d 704, 710 (9th Cir. 2005) (holding that causation in § 10(b) cases “requires a showing of both actual cause (‘transaction causation’) and proximate cause (‘loss causation’)” (citation omitted)); *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) (comparing “loss causation to the tort law concept of proximate cause,” and finding them similar); *Castellano*, 257 F.3d at 186 (“While transaction causation is generally understood as reliance, loss causation has often been described as proximate cause, meaning that the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material omission.”); *EP MedSystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 883 (3d Cir. 2000) (“In *Semerenko*, we equated loss causation with proximate cause, stating that there must be a ‘sufficient causal nexus between the loss and the alleged misrepresentation.’”) (quoting *Semerenko v. Cendant Corp.*, 223 F.3d 165, 184 (3d Cir. 2000)). Judge Posner has observed that “what securities lawyers call ‘loss causation’ is the standard common law fraud rule” of proximate cause, “merely borrowed for use in federal securities fraud cases.” *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 683 (7th Cir. 1990) (emphasis in original) (Posner, J., for the court); *accord* *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997) (stating § 10(b) “loss causation” is “nothing more than the ‘standard common law fraud rule’”) (citation omitted).

213. *Coffee*, *supra* note 106, at 544.

214. *See, e.g.,* *Estate of Lisle v. Comm’r*, 341 F.3d 364, 368 (5th Cir. 2003) (“Here there is a significant functional overlap of the two elements” of a Tax Court rule, “as the effort to prove underpayment and fraud is sustained by much the same evidence—establishing a kickback scheme to hide income proves both an underpayment and points toward fraud, on our facts.”); *Walker v. Schwalbe*, 112 F.3d 1127, 1132 (11th Cir. 1997) (discussing four-part First Amendment retaliatory demotion claim, the court concluded that “reasonable inferences from the same evidence” satisfied the third element and also satisfied the fourth element); *Automated Salvage Transp., Inc. v. NV Koninklijke KNP BT*, 106 F. Supp. 2d 606, 623 (D.N.J. 1999) (“As discussed below, the same material facts satisfy the first two elements—(1) material misrepresentation which was (2) made knowingly.”).

215. *See* *Daou Sys.*, 397 F.3d at 711 (citing *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1091 (9th Cir. 2002) for the proposition that falsity and scienter may be inferred from the same allegations); *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 685 (6th Cir. 2004) (stating that the nature of misrepresentations can create an inference of falsity and scienter); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106 (10th Cir. 2003) (falsity and scienter may both be inferred from allegations of GAAP violations); *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 744 (8th Cir. 2002) (citing *In re Vantive Corp.*, 283 F.3d at 1091); *Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000) (explaining that a sudden, large write-off creates an inference both that prior financial

common-law claims, the precedents never suggest that they must always be demonstrated separately. To the contrary, the primary focus in the case law was on reliance, with proximate cause discussed only occasionally and when plaintiffs sought recovery beyond direct out-of-pocket loss and immediate consequential damages. Nor is there any general requirement that the two be proved independently, let alone with independent evidence.

Consider a garden-variety fraud, in which the seller of a car—last year's model—put 85,000 miles on it in just one year of driving, but turns the odometer back to 15,000 miles before placing it on the used-car market. Now, who can doubt that turning the odometer back on a late-model car, from 85,000 miles to just 15,000, amounts to a material misrepresentation? That it is a misrepresentation made with scienter is a reasonable inference—indeed, a strong one—for turning an odometer back entails deliberate conduct, calculated to mislead. The fact that a plaintiff purchased the car, paying something approximating the going market rate for a car of that make, model, and (supposed) mileage, raises a reasonable inference of reliance. For we all know that, at common law, reliance may be inferred on the basis of a representation's materiality combined with purchase of the car.<sup>216</sup> The purchaser's reliance can easily be inferred from the fact that a car with high mileage is of considerably less value than one with low mileage. Had the plaintiff known the truth, he probably would not have purchased the car—or, at least, not on the same terms. As it happens, then, the same

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statements were false and that defendants were aware of the problem).

216. This is well-established, for “[t]he fact of reliance upon alleged false representations may be inferred from circumstances attending the transaction, which often times afford much stronger and more satisfactory evidence of the inducement which prompted the party defrauded to enter into the contract than direct testimony to the same effect.” 37 AM. JUR. 2d *Fraud and Deceit* § 477 (2004) (footnotes omitted); see also *id.* § 500. The legal encyclopedias have long explained:

when it is shown that the representations were false and material, and were made fraudulently, it is presumed that they were relied upon, and that the burden is upon the party who made them to show that the other did not rely upon them. Again, it has been held that when one has made a false representation which, from its nature, might induce another to enter into [a] contract on the faith of it, it will be inferred that the latter was induced thereby to contract, and it does not rest on him to show [by independent evidence] that he, in fact, relied upon the representation.

24 AM. JUR. *Fraud and Deceit* § 264 (1939) (footnote omitted). It may be noted that common law rules of evidence long prohibited testimony by the parties to the case. See, e.g., *Washington v. Texas*, 388 U.S. 14, 20 (1967) (“A party to a civil or criminal case was not allowed to testify on his own behalf for fear that he might be tempted to lie.”); 27 CHARLES ALAN WRIGHT & VICTOR JAMES GOLD, *FEDERAL PRACTICE AND PROCEDURE* § 6005, at 57 (1990) (“The common law at one time disqualified from testifying all parties and others with any pecuniary or proprietary interest in the outcome of a suit.”). Thus, under common law rules of evidence, reliance generally had to be inferred from a misrepresentation's materiality, coupled with conduct consistent with reliance on the misrepresentation. 24 AM. JUR. *Fraud and Deceit* § 288 (1939).

facts demonstrate the plaintiff's loss, which ordinarily would consist of the difference between the price paid for what appeared to be a low-mileage car, and the value received.

Given such an instance of garden-variety common-law fraud, no one would object that a court improperly "conflated" materiality, scienter, reliance (or "transaction causation") and proximate cause (or "loss causation") by observing that the same facts tend to demonstrate them all. Nor would many object if a court omitted an extended analysis of proximate cause as an independent element if all the purchaser sought to recover was out-of-pocket loss. In fact, proximate cause is seldom a point of dispute in the precedents when the plaintiff seeks out-of-pocket loss suffered as a consequence of fraud.

Proximate cause would come in to play, of course, if the plaintiff sought *more* than that immediate loss. For example, if the car broke down for reasons arguably related to high mileage, would the purchaser recover the cost of repairs as foreseeable consequential damages? If the car broke down as the purchaser drove his pregnant wife to the hospital, would the seller face liability for resulting medical complications? And so on. Obviously, proximate-cause concepts meaningfully cut off potential liability.<sup>217</sup> Surely, if the case did not go to trial until several years after the automobile purchase, disclosure-market-drop adherents would not insist that the "real cause" of plaintiff's loss should be attributed not to the original fraud, but to a "general decline" in the value of late-model cars, whose value materially falls for reasons obviously unrelated to the original fraud—though that apparently would be their contention in a securities case.

If in the typical market-fraud case, the same facts are apt to show both loss causation and transaction causation, important conceptual restrictions remain. In *Basic*, the Supreme Court emphasized that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade," *i.e.*, transaction causation, can break the

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217. The *Dura* opinion notes that, at least in the *fraud-on-the-market* context, an initial purchaser has no economic loss at the moment of purchase because he may sell the inflated shares "quickly before the relevant truth begins to leak out." *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631 (2005). That same view recently got the Federal National Mortgage Association, or "Fannie Mae," into hot water, resulting in Fannie Mae forfeiting \$7.5 million to the federal government. See Paul Muolo & Brian Collins, *Fannie to Pay \$7.5 MM in GNMA Fraud*, NAT'L MORTGAGE NEWS, Dec. 20, 2004. Fannie Mae believed that a mortgage lender had sold it fraudulent loans, but instead of informing regulators about the loans, Fannie Mae forced the lender to buy them back—allegedly aware that the buyback was made possible only because the lender passed on those same false loans to another purchaser. *Id.*

causational chain required to prevail in a securities-fraud case.<sup>218</sup> Thus, proof that the market price was not inflated because “the ‘market makers’ were privy to the truth,” or because inflation had been removed prior to purchase by other means, would defeat a claim—even if the plaintiff was individually misled and could show transaction causation.<sup>219</sup> Alternatively, a plaintiff who traded *knowing* that the price was manipulated “could not be said to have relied on the integrity of a price he knew had been manipulated.”<sup>220</sup> Thus, loss causation and transaction causation both remain critical elements even if in the typical case they are intertwined, and proved by the same facts.

History shows that courts generally have had little trouble separating out the two causation elements, and recognize that despite having satisfactorily alleged transaction causation plaintiffs may not necessarily have pleaded loss causation.<sup>221</sup> In the Seventh Circuit *Bastian* case, for example, plaintiffs invested \$600,000 in a limited partnership in direct reliance on defendants’ false claim of business competence.<sup>222</sup> Within three years the partnership was worthless, apparently due to declining *industry* profits.<sup>223</sup> Plaintiffs never alleged, despite amendment, that defendants’ misrepresentations inflated the securities’ acquisition price.<sup>224</sup> They instead claimed it was sufficient that they invested in reliance on defendants’ fraud, and contended that they did not have to show their loss was caused by the fraud.<sup>225</sup> Not surprisingly, the Seventh Circuit rejected plaintiffs’ contention and held that plaintiffs must allege that the fraud caused their injury, noting that other ventures in the industry survived despite declining profits.<sup>226</sup> If courts can distinguish loss causation and transaction causation when the distinction matters, there is little reason to adopt draconian formulations of loss causation to defeat investors’ claims in those cases where proof of reliance and loss legitimately converge.

### *C. Judges and Juries Can be Trusted to Determine Complex Issues*

A central premise underlying Professor Coffee’s thesis that “losses”

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218. *Basic Inc. v. Levinson*, 485 U.S. 224, 248 (1988).

219. *Id.*

220. *Id.* at 249.

221. *See, e.g., Bastian v. Petren Res. Corp.*, 892 F.2d 680, 684 (7th Cir. 1990) (“They have alleged the cause of their entering into the transaction in which they lost money but not the cause of the transaction’s turning out to be a losing one.”).

222. *Id.* at 682.

223. *Id.* at 684.

224. *Id.*

225. *Id.* at 683.

226. *Id.* at 684.



require a visible market reaction to disclosures is that judges and juries cannot be trusted to sort out a misstatement's real financial impact.<sup>227</sup> This premise fails on several fronts.<sup>228</sup>

First, the charge that losses can be hard to determine could be leveled in virtually every area of civil litigation that is more complicated than the simplest tort action, but that fact does not keep judges and juries from sorting out those complicated disputes.<sup>229</sup> Even in personal-injury cases, juries must consider medical evidence and expert opinion, and may even have to place a dollar amount on lost future income and on pain and suffering.<sup>230</sup> Losses and damages in myriad contracts, patents, or antitrust disputes are considered, weighed, and soundly decided every day by juries and judges across this nation.<sup>231</sup> Securities-fraud cases are surely not that different from the judgments and decisions that must be made in these occasionally esoteric areas.

Second, both sides in large, expensive securities-fraud actions will ordinarily have at their disposal experts of the highest caliber to test each other, all willing to deconstruct for laypersons the intricacies of the fraud and its effect upon the market.<sup>232</sup> Expert economists and

227. See, e.g., *Coffee*, *supra* note 106, at 533 ("The key problem . . . involves the limited institutional competence of judges and juries to infer losses."). See also *id.* at 538 ("Even if judges and juries are competent . . . they cannot reliably measure its financial impact.").

228. See discussion *infra* Part IV.C.

229. See, e.g., *Synovus Trust Co., N.A. v. Honda Motor Co.*, 223 F.R.D. 699, 701 (M.D. Ga. 2004) (stating that "[i]ssues of negligence, product defect, contributory negligence, and damages present unique facts that are particularly well suited for evaluation by members of the community using their common experiences and wisdom.").

230. See, e.g., *Mercado v. Ahmed*, 974 F.2d 863, 866–68 (7th Cir. 1992) (affirming district court's ruling that the jury properly evaluated the plaintiff's future medical expenses, disability, and lost wages); *Champion Home Builders v. Shumate*, 388 F.2d 806, 810 (10th Cir. 1967) (holding that the jury verdict awarding medical expenses, compensation for injuries, and residual effects in personal injury case was not excessive).

231. *SRI Int'l v. Matsushita Elec. Corp.*, 775 F.2d 1107, 1130 (Fed. Cir. 1985) The court stated:

There is thus no warrant for limiting even complex patent litigation to an exclusive professional ritual engaged in only by lawyers and judges. Elbowing to one side the Seventh Amendment, and the compelling social and democratic (much less constitutional) bases for its existence, would be at best an unseemly judicial exercise.

*Id.* See also *Cotten v. Witco Chem. Corp.*, 651 F.2d 274, 276 (5th Cir. 1981) (reversing district court's denial of jury trial in antitrust matter based upon a "complexity exception," where the court was "confident that if such an exception exists, it is only to be applied when the trial judge finds that the case is so complex that a jury *could not* render a rational decision based upon a reasonable understanding of the evidence and applicable rules of law"); *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 885 (2d Cir. 1972) (rejecting appellant's contention that the trial judge "totally failed to provide the jury with the basic tools it needed to understand the nature of a claim arising under § 10(b) of the Securities Exchange Act of 1934 . . .").

232. *United States v. Bilzerian*, 926 F.2d 1285, 1294 (2d Cir. 1991) ("Particularly in complex cases involving the securities industry, expert testimony may help a jury understand unfamiliar

securities-law professors render opinions several dozens of times a year in larger securities actions.<sup>233</sup> Once hired, the experts can produce event studies, time/value line charts, and regression analyses all designed to help factfinders (either juries or judges) come to reasonable conclusions.<sup>234</sup> The practice is well established in the lower courts.<sup>235</sup>

Proffered skepticism about judges' and juries' abilities to handle securities-fraud cases thus rings hollow.<sup>236</sup> "The opponents of the use of juries in complex civil cases generally assume that jurors are incapable of understanding complicated matters. This argument unnecessarily and improperly demeans the intelligence of the citizens of this Nation."<sup>237</sup>

## V. CONCLUSION

Any insistence that "loss" cannot occur unless the full scope of a securities fraud is publicly disclosed, with a corresponding visible stock-price drop, is an artificial construct at odds both with precedent and the realities of the modern marketplace. As still-unfolding events have illustrated, sophisticated financial frauds take many forms and shapes. The manner in which each fraud produces investors' losses rarely fits into the cookie-cutter form that defendants and commentators like Professor Coffee would employ—indeed, as the Supreme Court explains, a "tangle of factors" affects a security's price. Moreover, some of the major wrongdoers' culpability may not be definitively unearthed until long after any vestige of inflation has been drained from the corporation's stock price. But the happenstance of a final disclosure's timing or magnitude does nothing to lessen the very real

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terms and concepts.").

233. See, e.g., *id.* (upholding use of Professor Coffee's expert testimony in securities action).

234. On the use of expert analysis and event studies in calculating inflation resulting from fraud while excluding other market variables, see Fischel, *supra* note 127, at 17–19, and Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 897–911 (1990). See also *Blackie v. Barrack*, 524 F.2d 891, 909 n.25 (9th Cir. 1975) ("[F]act finder may rely on other methods of determining actual value on the date of purchase, including expert testimony on actual value.").

235. *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 832 (8th Cir. 2003) (declining to "attach dispositive significance to the stock's price movements absent sufficient facts and expert testimony, which cannot be considered at this procedural juncture"); *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983) (in securities cases, "amount of damages is a jury issue although the services of a special master or the testimony of an expert witness . . . may be particularly helpful") (footnotes omitted), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

236. See discussion *supra*, Part IV.C.

237. *In re U.S. Fin. Sec. Litig.*, 609 F.2d 411, 429–30 (9th Cir. 1979); see also Morgan v. District of Columbia, 824 F.2d 1049, 1062 (D.C. Cir. 1987) ("We traditionally trust juries to make far more complex evaluations without the interposition of experts.").

economic losses that innocent investors experience when, after purchasing securities inflated by those wrongdoers' actions, relevant truths enter the marketplace and remove the purchase-price inflation. The Supreme Court has spoken, and refused to adopt the stringent requirements argued by Dura or its amici.