DURA DURESS: THE SUPREME COURT MANDATES A MORE RIGOROUS PLEADING AND PROOF REQUIREMENT FOR LOSS CAUSATION UNDER RULE 10B-5 CLASS ACTIONS

JEROD NEAS*

The Supreme Court's holding in Dura Pharmaceuticals, Inc. v. Broudo *imposes a heightened pleading requirement for private plaintiffs in misrepresentation or omission securities class actions under Rule 10b-5. The Court verified that a plaintiff must adequately plead loss causation in its complaint and rejected the Ninth Circuit's interpretation of the loss causation standard. The Supreme Court held that the plaintiff's pleadings in* Dura *did not meet the loss causation requirement of the Private Securities Litigation Reform Act ("PSLRA"). The Court also rejected the Ninth Circuit's requirement that the alleged misconduct merely "touch upon" the economic loss. Instead, the Supreme Court held that a plaintiff must allege* and *prove that the misconduct "proximately" caused the subsequent loss. This Note attempts to clarify this area by first outlining the elements required for recovery under 10b-5 class actions and tracing the development of loss causation. This Note then analyzes the Supreme Court's rejection of the Ninth Circuit's interpretation of loss causation in favor of a "proximate" standard and explains some important considerations and misconceptions of loss causation. Finally, this Note attempts to explain the Court's new pleading requirements for loss causation and suggests an alternate version of that standard.*

INTRODUCTION

The Supreme Court's holding in *Dura Pharmaceuticals, Inc. v. Broudo* imposes a heightened pleading requirement for private plaintiffs in misrepresentation or omission securities class-actions under Rule 10b-

* Candidate for Juris Doctor, University of Colorado School of Law, May 2007; Bachelor of Science in Business Administration, University of Colorado, with concentrations in Finance and Accounting. As a law student, the author worked as a summer associate with the Securities and Exchange Commission and the law firm of Rothgerber, Johnson & Lyons. The author thanks his wife, Julie, for her encouragement, support, and unwavering tolerance of him during law school.

5.[1] The Court verified that a plaintiff must adequately plead loss causation in its complaint and rejected the Ninth Circuit's interpretation of the loss causation standard.[2] Under the Ninth Circuit's original interpretation, a plaintiff could plead loss causation by merely alleging that "the price at the time of purchase was overstated" and there was "sufficient identification of the cause."[3] Moreover, the Ninth Circuit's loss causation standard did not require a showing that the stock price dropped following a corrective disclosure because the court assumed that "the injury occurs at the time of the transaction."[4] Accordingly, the circuit concluded that "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred."[5]

The Supreme Court disagreed with this interpretation of loss causation, holding that the plaintiff's pleadings in *Dura* did not meet the loss causation requirement of the Private Securities Litigation Reform Act ("PSLRA").[6] The Court rejected the Ninth Circuit's requirement that the alleged misconduct merely "touch upon" the economic loss.[7] Based on the Court's new standard, alleging that the price of the security was artificially inflated at the time of purchase is not enough for a private plaintiff to show loss causation.[8] Instead, the Supreme Court held that a plaintiff must allege *and* prove that the misconduct "proximately" caused the subsequent loss.[9] This standard requires the plaintiff to plead facts that tend to show a strong relationship between the defendant's misrepresentation or omission and the drop in market price of the security.[10] This strong relationship requires that a plaintiff sell her securities at a net loss,

1. 544 U.S. 336 (2005). Congress enacted the Private Securities Litigation Reform Act in 1995, requiring a plaintiff to state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind and to prove that the act or omission of the defendant caused the loss for which the plaintiff seeks to recover damages. 15 U.S.C § 78u-4(b) (2000).

2. *Dura*, 544 U.S. at 346. The Supreme Court defined loss causation as "a causal connection between the material misrepresentation and the loss." *Id.* at 342; *see also* THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 12.11[1], [3] (5th ed. 2002) (defining loss causation as the causal connection between the material misrepresentation and the loss suffered by the plaintiff).

3. Broudo v. Dura Pharm., Inc., 339 F.3d 933, 938 (9th Cir. 2003).

4. *Id.*

5. *Id.*

6. *Dura*, 544 U.S. at 346. The PSLRA sets out specific pleading and proof requirements for private securities class actions under Rule 10b-5. 15 U.S.C § 78u-4(b) (2000). In particular, the Act requires the plaintiff to prove that the act or omission of the defendant "caused the loss for which the plaintiff seeks to recover damages." *Id.* § 78u-4(b)(4).

7. *Dura*, 544 U.S. at 343.

8. *Id.*

9. *Id.* at 346.

10. *Id.* at 342–43 (finding that the causal connection between an inflated share purchase price and any later economic loss is not invariably strong).

relatively close in time to the alleged misrepresentation, and that the misrepresentation be at least a substantial factor—if not the predominate cause—for the share price decline.[11] Consequently, this new standard poses a substantial obstacle for plaintiffs who choose to bring actions involving publicly traded securities under the "fraud-on-the-market" theory[12] by requiring a direct causal link to the alleged loss in value. However, the Court did not outline how direct or substantial the causal link must be between the misrepresentation and any later loss. Rather, the Court simply rejected the Ninth Circuit's expansive interpretation of loss causation, requiring instead that a plaintiff allege more than that the misrepresentation merely "touches upon" the plaintiff's loss.[13] The Court further explained that the law requires that the misrepresentation "proximately" cause the alleged loss, re-emphasizing the tortious element of a Rule 10b-5 claim.[14]

With its holding in *Dura*, the Supreme Court has further confused the already complicated area of securities class actions. This Note attempts to clarify this area by first outlining the elements required for recovery under 10b-5 class actions and tracing the development of loss causation. This Note then analyzes the Supreme Court's rejection of the Ninth Circuit's interpretation of loss causation in favor of a "proximate" standard and explains some important considerations and misconceptions of loss causation. Finally, this Note attempts to explain the Court's new pleading requirements for loss causation and suggests an alternate version of that standard.

I. BACKGROUND

In the wake of the stock market crash of 1929 and in response to widespread allegations of abuses in the securities industry, Congress enacted the Securities Act of 1933 ("Securities Act")[15] and the Securities Exchange Act of 1934 ("Exchange Act").[16] The Securities Act is a rela-

11. *Id.* at 343 ("Other things being equal, the longer the time between purchase and sale, . . . the more likely that other factors caused the [economic] loss.").

12. The "fraud-on-the-market" theory presumes transaction causation when:

> (1) . . . the defendant made public misrepresentations; (2) . . . the misrepresentations were material; (3) . . . the shares were traded on an efficient market; (4) . . . the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) . . . the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.

Basic, Inc. v. Levinson, 485 U.S. 224, 248 n.27 (1988) (citation omitted).

13. *Dura*, 544 U.S. at 343.

14. *Id.* at 346.

15. 15 U.S.C. § 77a (2000).

16. 15 U.S.C. § 78a (2000).

tively narrow statute that is primarily concerned with preventing fraud and requiring certain disclosures in connection with the initial offerings of securities.[17] The Exchange Act, on the other hand, is a much broader statute that is principally concerned with the trading of securities on national exchanges and in the trading markets after initial public distribution.[18] Section 10(b) of the Exchange Act specifically outlaws "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities & Exchange] Commission may prescribe."[19] Pursuant to this authority, the Securities & Exchange Commission ("Commission") promulgated Rule 10b-5—a general antifraud provision—to combat abuses in the purchase or sale of securities on these secondary markets.[20] This provision has been referred to as "a judicial oak which has grown from little more than a legislative acorn."[21] The Rule states:

> It shall be unlawful for any person . . . ,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
> in connection with the purchase or sale of any security.[22]

The plain language of Section 10(b) and Rule 10b-5 do not expressly provide for a private cause of action, stating only that conduct in "contravention" of Commission rules and regulations is prohibited.[23] However, the Commission, given its limited resources, is unable to effectively police the entire securities industry.[24] Consequently, a private remedy for violating this Commission rule has been well established by the Supreme Court.[25] The Supreme Court has concluded that "the possi-

17. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 (1975).
18. *Id.*
19. 15 U.S.C. § 78j(b) (2000).
20. 17 C.F.R. § 240.10b-5 (2005).
21. *Blue Chip Stamps*, 421 U.S. at 737.
22. 17 C.F.R. § 240.10b-5 (2005).
23. 15 U.S.C. § 78j(b).
24. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) ("Time does not permit [the Commission to conduct] an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value . . . .").
25. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right

bility of civil damages or injunctive relief serves as a most effective weapon" in the enforcement of Commission rules and regulations.[26] Moreover, the Court has repeatedly held that "private enforcement of Commission rules" provides "a necessary supplement to Commission action."[27]

II. ELEMENTS OF A PRIVATE 10B-5 CLAIM

The elements of a private cause of action under Section 10(b) and Rule 10b-5 are similar to the elements in a common-law fraud action.[28] To establish a private claim under Rule 10b-5, a plaintiff must show: (1) a material misrepresentation or omission;[29] (2) in connection with the purchase or sale of a security;[30] (3) scienter;[31] (4) reliance;[32] (5) economic loss;[33] and (6) loss causation.[34]

A. Material Misrepresentation or Omission

To recover under Rule 10b-5, a plaintiff must first show that the defendant made a material misrepresentation or omitted a material fact.[35] Materiality depends upon the "significance the reasonable investor would place on the withheld or misrepresented information."[36] Materiality is

---

of action is implied under § 10(b)." (citation omitted)).

26. *J.I. Case Co.*, 377 U.S. at 432.

27. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (citing *J.I. Case Co.*, 377 U.S. at 432); *see also* Deposit Guar. Nat'l Bank v. Roper, 445 U.S. 326, 339 (1980) (sanctioning the need to aggregate small individual claims in a class action in order to correct wrongs not remedied by public actions).

28. *Blue Chip Stamps*, 421 U.S. at 744 (finding that "the tort of misrepresentation and deceit" certainly has some relationship to Rule 10b-5); *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 243–44 (1988).

29. *See Basic*, 485 U.S. at 231–32. While a misrepresentation or omission is the most common type of action, Rule 10b-5 also proscribes fraudulent practices, courses of business, devices, schemes, and artifices to defraud. 17 C.F.R. § 240.10b-5 (2005).

30. *See Blue Chip Stamps*, 421 U.S. at 730–31.

31. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976).

32. Also called "transaction causation" when the action is in regards to a publicly traded security. In these "fraud-on-the-market cases," reliance is presumed. *See Basic*, 485 U.S. at 248–49 (inconclusively presuming that the price of a publicly traded share reflects a material misrepresentation and that plaintiffs have relied upon that misrepresentation as long as they would not have bought the shares in its absence).

33. 15 U.S.C § 78u-4(b)(4) (2000).

34. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

35. 17 C.F.R. § 240.10b-5 (2005).

36. *Basic*, 485 U.S. at 240 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").

usually fact specific and difficult to quantify.[37] The statement cannot be merely "false or incomplete, if the misrepresented fact is otherwise insignificant."[38] Instead, materiality is established if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision.[39] Therefore, the test for materiality is an objective one, based on the "significance" of the given facts to a "reasonable investor."[40]

B. In Connection With the Purchase or Sale of Any Security.

The second element of a Rule 10b-5 violation is that the misstatement or fraudulent activity must be "in connection with the purchase or sale of any security."[41] The Supreme Court has consistently interpreted this element broadly, requiring only that the deceptive practice or misstatement "touch upon" a securities transaction.[42] The fact that a transaction "is not conducted through a securities exchange or an organized over-the-counter market" is irrelevant to the application of this element.[43] Moreover, the "purchase or sale" language can be established by almost any transaction involving securities. For example, in *SEC v. National Securities*,[44] the management of the defendant corporation materially misled plaintiff shareholders into accepting a merger. The defendant argued that because shareholders merely traded shares of the old corporation for shares of the new one, there was no "sale" within the meaning of Section 10(b) or Rule 10b-5.[45] The Supreme Court held that when a shareholder loses his status as shareholder in one company and becomes a shareholder in another company, the "purchase or sale" aspect of Rule 10b-5 is satisfied.[46] The Court concluded that the "shareholders 'purchased' shares in the new company by exchanging them for their old stock."[47] Although there was no monetary exchange, and the shareholders still had a similar ownership interest in the corporation, the Court concluded that a "purchase or sale" had taken place.[48]

---

37. *Basic*, 485 U.S. at 240.
38. *Id.* at 238.
39. *TSC Indus., Inc.*, 426 U.S. at 449.
40. *Id.* at 445.
41. 17 C.F.R. § 240.10b-5 (2005).
42. *See, e.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12–13 (1971).
43. *Id.* at 10.
44. SEC v. Nat'l Sec., Inc., 393 U.S. 453, 467 (1969).
45. *Id.* at 465.
46. *Id.* at 467.
47. *Id.*
48. *Id.* at 464. In determining whether there has been a purchase or sale for the purpose

C. Scienter

To recover under Rule 10b-5, a private plaintiff must also show that the defendant acted with a culpable state of mind—or "scienter."[49] Section 10(b) of the Exchange Act provides that it is unlawful to use or employ "any manipulative or deceptive device or contrivance" in contravention of Commission rules.[50] Based on this statutory language—particularly the terms "manipulative or deceptive"—the Supreme Court has determined that a plaintiff must establish that the defendant acted with a wrongful state of mind.[51]

Early case law interpreting the scienter requirement was almost incoherent, with some courts finding liability without any specific state of mind and others requiring some form of guilty knowledge.[52] In response, the Supreme Court in *Ernst & Ernst v. Hochfelder* defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."[53] Although the Court held that negligent conduct alone was *not* sufficient to satisfy the scienter element, it did not directly decide what state of mind *is* necessary in 10b-5 actions.[54] While the Court noted that "recklessness" can constitute intentional conduct under certain circumstances, it did not address whether recklessness satisfies the scienter element *per se*.[55] Nevertheless, as a result of the *Hochfelder* decision, cir-

---

of Rule 10b-5, some courts have fashioned a test from the Supreme Court's decisions in *National Securities* and *Blue Chip Stamps*. *See, e.g.*, Seolas v. Bilzerian, 951 F. Supp. 978, 987 (D. Utah 1997); Gelles v. TDA Indus., Inc., No. 90 Civ. 5133, 1993 U.S. Dist. LEXIS 9779, at *16 (S.D.N.Y. July 16, 1993). These courts consider whether (1) there was a transfer of ownership or control of the security, (2) there was some exchange of value, (3) the suit is consistent with the remedial purpose of the Securities Exchange Act, (4) there was a change in the fundamental nature of the security, and (5) there was a direct effect on the conduct of the securities market, or an indirect effect on investors' abilities to make knowing decisions. *Gelles*, 1993 U.S. Dist. LEXIS 9779, at *16.

49. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976).

50. 15 U.S.C. § 78j(b) (2000).

51. *Hochfelder*, 425 U.S. at 197.

52. Some opinions suggested that knowledge was not required or that negligence alone was sufficient. *See, e.g.*, White v. Abrams, 495 F.2d 724, 734 (9th Cir. 1974) (rejecting scienter or any other state of mind as a requisite element of a 10b-5 action); Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967) (finding that negligence is sufficient); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963) (finding that knowledge of the falsity is not required). Other courts held that some type of knowledge of wrongdoing or intent to defraud was required. *See, e.g.*, Clegg v. Conk, 507 F.2d 1351, 1361–62 (10th Cir. 1974) (requiring an element of conscious fault); Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (requiring either willful or reckless conduct).

53. *Hochfelder*, 425 U.S. at 193 n.12.

54. *Id.*

55. *Id.*

cuit courts have overwhelmingly adopted the position that recklessness is sufficient to impose liability under Rule 10b-5.[56]

D. Reliance/Transaction Causation

The plaintiff in a private 10b-5 action may have to show reliance upon the material misrepresentations or omissions in entering into the transaction that eventually caused the loss.[57] Rule 10b-5 proscribes three distinct activities—each dealing with particular conduct.[58] Therefore, whether a plaintiff is required to prove reliance will depend upon which provision of Rule 10b-5 the action is based.[59] In *Affiliated Ute*, the Supreme Court reviewed the language of Rule 10b-5, noting that paragraph (b) proscribes "untrue statement[s] of a material fact" or omissions of a "material fact."[60] On the other hand, the Court noted that paragraph (a) broadly prohibits any "device, scheme or artifice to defraud," and paragraph (c) forbids any "act practice or course of business which operates . . . as a fraud."[61] The Court recognized that an "untrue statement of a material fact" by the defendant would naturally require some sort of reliance on the part of the plaintiff for a cause of action to accrue.[62] Conversely, the Court recognized that a "device, scheme," or "practice" does not suggest the existence of specific reliance on the part of the plaintiff.[63] Therefore, when a plaintiff brings an action based upon a misrepresentation or omission of a material fact, she must also prove that she relied upon that misrepresentation in entering into the transaction. If, however,

---

56. Woods v. Barnett Bank of Ft. Lauderdale, 765 F.2d 1004, 1010 (11th Cir. 1985); Kehr v. Smith Barney, Harris Upham & Co., 736 F.2d 1283, 1286 (9th Cir. 1984); Dirks v. SEC, 681 F.2d 824, 844 (D.C. Cir. 1982); Hackbart v. Holmes, 675 F.2d 1114, 1117–18 (10th Cir. 1982); Stokes v. Lokken, 644 F.2d 779, 783 (8th Cir. 1981); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961–62 (5th Cir. 1981); Sharp v. Coopers & Lybrand, 649 F.2d 175, 193 (3d Cir. 1981); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979); Cook v. Avien, Inc., 573 F.2d 685, 692 (1st Cir. 1978); Rolf v. Blyth, 570 F.2d 38, 46 (2d Cir. 1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044 (7th Cir. 1977). The Tenth Circuit has defined recklessness as "'an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" *Hackbart*, 675 F.2d at 1118 (citations omitted).

57. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341 (2005); Trident Inv. Mgmt., Inc. v. Amoco Oil Co., 194 F.3d 772, 778 (7th Cir. 1999) (finding that "transaction causation" is similar to the "but for" causation element of common-law fraud); *In re* Catanella Sec. Litig., 583 F. Supp. 1388, 1414–15 (E.D. Pa. 1984).

58. 17 C.F.R. § 240.10b-5 (2005).

59. *Id.*

60. Affiliated Ute Citizens v. United States, 406 U.S. 128, 152–53 (1972).

61. 17 C.F.R. § 240.10b-5.

62. *Affiliated Ute*, 406 U.S. at 153.

63. *Id.*

a plaintiff bases the action upon a deceptive device or practice, positive proof of reliance is not a prerequisite to recovery.[64]

A problem with showing reliance can arise in a misrepresentation or omission action if the plaintiff purchased the security on a national market and had no direct contact or privity with the defendant. Because it would be particularly difficult to prove reliance under those circumstances, courts assume reliance under the "fraud-on-the-market" theory.[65] This theory supposes that when "materially misleading statements" have been disseminated into the securities market, "the reliance of individual plaintiffs on the integrity of the market price may be presumed."[66] The presumption is that "most publicly available information is reflected in market price," and that investors who buy or sell stock at the price set by the market do so "in reliance on the integrity of that price."[67] Therefore, an investor's reliance on any public material misrepresentations or omissions may be presumed for purposes of a Rule 10b-5 action. However, if the plaintiff were in privity with the defendant or purchased the securities directly from the party making the misrepresentation, the plaintiff would need to show that he relied on the misrepresentation or omission.

E. Economic Loss

Under Rule 10b-5, a plaintiff's recovery is generally limited to damages that the plaintiff actually suffered.[68] Furthermore, failure to show actual damages is a "fatal defect" in a Rule 10b-5 class action.[69] The Private Securities Litigation Reform Act further limits the amount of damages recoverable if the plaintiff chooses to establish her economic harm based on the market price of the security.[70] In such a situation, the statute limits damages to the difference between the plaintiff's "purchase or sale price paid or received" and "the mean trading price"[71] of the security over the subsequent 90 day period after the misrepresentation or

64. 17 C.F.R. § 240.10b-5; *Affiliated Ute*, 406 U.S. at 153.

65. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).

66. *Id.*

67. *Id.* In *Basic*, the Court noted that "'in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business." *Id.* at 241 (quoting Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986)).

68. *See* 15 U.S.C. § 78u-4(e) (2000).

69. Feldman v. Pioneer Petroleum, Inc., 813 F.2d 296, 302 (10th Cir. 1987).

70. 15 U.S.C. § 78u-4(e)(1).

71. *Id.* The "mean trading price" of the security is the average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period. *Id.* § 78u-4(e)(3).

fraud is disseminated to the public.[72] In this way, the PSLRA attempts to insulate price fluctuations in the securities that are unrelated to the misrepresentation or omission.[73] This limitation on damages is consistent with the "fraud-on-the-market" theory of presumptive reliance. That is, the "fraud-on-the-market" theory supposes that the general securities markets have relied on the misrepresentation in setting the price of the security. When correct information with respect to the misrepresentation is disseminated to the public, the market will then adjust the price of the security to reflect the new, correct information. Theoretically, the market will determine the value of the misrepresentation by "correcting" the share price of the security after the information becomes generally known. Thus, the PSLRA attempts to limit recovery to the theoretical market value of the misrepresentation.[74]

This recovery limitation creates an interesting dilemma for a private plaintiff. If the plaintiff wishes to establish damages without reference to the market price of the security, then theoretically that plaintiff would not be limited to the market's valuation of the misrepresentation. However, a plaintiff pursuing this avenue of recovery would surrender the opportunity to rely on the "fraud-on-the-market" theory of presumptive reliance. While this course of action might increase recoverable damages, the plaintiff would have the added burden of showing justified reliance on the misrepresentation or omission.

F. Loss Causation

Finally, a plaintiff must establish a causal connection between her economic loss and the misrepresentation or omission to recover under Section 10(b) and Rule 10b-5.[75] The "loss causation" element arises when "misrepresentations or omissions caused the economic harm" for which the plaintiff seeks to recover.[76] This element is frequently associated with the "proximate cause" element in common law fraud actions and requires a nexus between the plaintiff's injury and the defendant's wrongful conduct.[77] However, courts have been divided as to how strong the relationship between the misconduct and the economic harm

72. *Id.* § 78u-4(e)(3).
73. *Id.*
74. *Id.*
75. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 340 (2005).
76. Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974).
77. Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981) (finding that when the misrepresentation "touches upon the reasons for the investment's decline in value," the loss causation element is satisfied).

must be for recovery under Rule 10b-5.[78] Consequently, loss causation has been described as one of the most confusing elements of a Rule 10b-5 claim.[79]

Traditionally, courts have taken either a narrow view or an expansive view of loss causation.[80] The narrow view requires a plaintiff to establish a relatively strong relationship or direct causal link between the defendant's conduct and any subsequent drop in the value of the security.[81] On the other hand, the expansive view of loss causation is less rigorous, requiring only that the plaintiff show "some causal nexus" between the improper conduct and the plaintiff's losses.[82] However, both views suffer from the same deficiency: neither quantifies how strong the relationship between the misconduct and the loss must actually be. To be sure, the narrow view requires a stronger relationship between the misconduct and subsequent drop in share price than the expansive view. Therefore, a detailed understanding of the evolution and purpose of loss causation is necessary to evaluate and quantify the element.

III. THE HISTORY AND CONFUSION OF LOSS CAUSATION

In order to recover under Rule 10b-5, a plaintiff must prove two distinct elements of causation: loss causation and transaction causation.[83] However, early courts did not distinguish between these two elements in securities fraud cases and instead looked to the common law element of "reliance" to ensure that the misrepresentations actually caused the plaintiff's harm. For example, in *List v. Fashion Park, Inc.*, the Second Circuit explained that the element of "reliance" establishes whether "the

78. *Compare* Binder v. Gillespie, 184 F.3d 1059, 1066 (9th Cir. 1999) (finding that loss causation requires that the fraud had "something to do with" the decline in the value of the investment) *with* Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 96 (2d Cir. 2001) (finding that the plaintiff must prove that the damages it suffered were a "foreseeable consequence of the misrepresentation").

79. Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357, 357 (1991) (describing the loss causation element as "'ungainly,' 'exotic,' 'confusing,' and even 'unhappy'").

80. David S. Escoffery, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 FORDHAM L. REV. 1781, 1797 (2000).

81. Robbins v. Koger Props., 116 F.3d 1441, 1447 (11th Cir. 1997); *Huddleston*, 640 F.2d at 549 n.24 (noting that loss causation requires "a direct causal link between the misstatement and the claimant's economic loss").

82. Broudo v. Dura Pharm., Inc., 339 F.3d 933, 938 (9th Cir. 2003) (finding that the loss causation element "merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause"); Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996); *In re* Control Data Corp. Sec. Litig., 933 F.2d 616, 619 (8th Cir. 1991).

83. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (U.S. 2005).

misrepresentation is a *substantial factor* in determining the course of conduct which results in [the recipient's] loss."[84] The court asserted that "reliance" can also "certify that the conduct of the defendant actually caused the plaintiff's injury."[85] Therefore, early courts used a single element of reliance to establish that the defendant's conduct was a necessary and proximate cause of the plaintiff's loss.

After *Fashion Park*, the Second Circuit faced the difficult task of allowing recovery under Rule 10b-5 without the requisite reliance element.[86] To that end, the court determined that the reliance element of a Rule 10b-5 violation should be split into two separate components: loss causation and transaction causation.[87] In *Schlick v. Penn-Dixie Cement Corp.*, the defendant corporation ("Penn-Dixie") obtained majority control of Continental Steel Corporation ("Continental") in which the plaintiffs were minority shareholders.[88] The defendant subsequently caused a merger between Penn-Dixie and Continental at an unfair exchange ratio.[89] Because state law authorized a merger by a majority vote of the shares, the minority shareholders were forced to accept the terms of the merger.[90] Consequently, the plaintiffs could not show that they had relied upon any of Penn-Dixie's misrepresentations.[91] Nevertheless, the Second Circuit found that misrepresentations caused the plaintiff's harm by generating an unfair exchange ratio, even though reliance—or transaction causation—was lacking.[92] The court concluded that if the case had been based "solely upon material omissions or misstatements . . . there would have to be a showing of both *loss causation* . . . and *transaction causation*."[93] However, because the complaint alleged a "scheme to defraud," the court stated that the plaintiff need not show transaction causation to recover.[94] Instead, the court held that the plaintiff need show only that the defendant's actions were the *cause* of the plaintiff's loss,[95] essentially eliminating the reliance requirement when the case is brought under either paragraph (a) or paragraph (c) of Rule 10b-5. As noted above, paragraphs (a) and (c) of Rule 10b-5 proscribe fraudulent

84. List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965) (quoting RESTATEMENT OF TORTS § 546 (1938) (emphasis added)).
85. *Id.*
86. *See* Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 381 (2d Cir. 1974).
87. *See id.* at 380.
88. *Id.* at 376.
89. *Id.*
90. *See id.* at 377 n.3.
91. *See id.* at 377–78.
92. *Id.* at 381.
93. *Id.* at 380.
94. *Id.* at 381.
95. *Id.*

devices, schemes, and practices.[96] Paragraph (b), on the other hand, prohibits misrepresentations and omissions and requires some level of reliance.[97]

Unfortunately, the court offered no case law or detailed discussion on how it came to distinguish loss causation from transaction causation.[98] In his concurrence, Judge Frankel lamented that he was unable to join completely in the opinion because of the portions that distinguished the concepts of "loss causation" and "transaction causation."[99] He criticized the use of such scholarly terms because of their "uncertain implications."[100] Although he conceded that the distinction may eventually prove to be useful, he was not convinced that the court ought to be "committed to their employment" when they were not briefed or argued.[101] Frankel concluded that he was "not prepared to find [the] labels either useful or harmful," finding only that "being unnecessary, they ought not to enter into an opinion on the limited questions before the court."[102]

Following *Penn-Dixie Cement*, the bifurcation of reliance into loss causation and transaction causation soon began to take hold. Before long, other courts had adopted these scholarly terms, even if they did not have a full understanding of their meanings.[103]

A. The Fraud-on-the-Market Theory Complication

Once courts began to require transaction *and* loss causation, a potential plaintiff would have to show that the defendant's misrepresentation caused both the plaintiff's transaction and the plaintiff's damages.[104]

---

96. 17 C.F.R. § 240.10b-5 (2005).

97. *See supra* Part II.D. Although the court was correct in finding that reliance is not required when the complaint alleges a "scheme" to defraud, it was unnecessary for the court to split the reliance element into two separate and distinct parts. Instead, the court should have merely explained the language of the Rule, noting that an "artifice" or "device" does not necessarily entail a misrepresentation or omission that requires a showing of reliance.

98. *Penn-Dixie*, 507 F.2d. at 380.

99. *Id.* at 384 (Frankel, J., concurring).

100. *Id.*

101. *Id.*

102. *Id.*

103. *See, e.g.*, Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975); Valente v. Pepsico, Inc., 454 F. Supp. 1228, 1246 (D. Del. 1978); Billet v. Storage Tech. Corp., 72 F.R.D. 583, 586 (S.D.N.Y. 1976). *But see* St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith Inc., 562 F.2d 1040, 1048 n.11 (8th Cir. 1977) (finding "little relevance in pursuing a distinction" between loss causation and transaction causation).

104. Although courts sometimes refer to loss causation as the "proximate" cause of injury and transaction causation as the "cause in fact" of injury, such a classification is probably incorrect. *See, e.g.*, Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 186 (2d Cir. 2001); Trident Inv. Mgmt., Inc. v. Amoco Oil Co., 194 F.3d 772, 778 (7th Cir. 1999) (finding that

However, these requirements were further complicated by the advent of the fraud-on-the-market theory and its presumption of reliance. In *Basic Inc. v. Levinson*, the Supreme Court implicitly sanctioned the fraud-on-the-market theory of presuming reliance in misrepresentation or omission cases.[105] This theory asserts that when "materially misleading statements" have been disseminated into the securities market, "the reliance of individual plaintiffs on the integrity of the market price may be presumed."[106] Such reliance is based upon the assumption that "most publicly available information is reflected in market price" and investors who buy or sell stock at the price set by the market do so "in reliance on the integrity of that price."[107] However, this holding seems to suggest that both transaction causation and loss causation may be assumed under the fraud-on-the-market theory.[108] In *Basic*, the Court noted that "materially misleading statements" are automatically "reflected in [the] market price" of a security.[109] Thus, false and misleading statements immediately alter the price of the security, as well as the price paid by a potential plaintiff.[110] Because the price of the security is not the true reflection of the security's value, the potential plaintiff is theoretically harmed at the time of the transaction by purchasing the security at an artificially inflated price.

In *In re Phillips Petroleum Securities Litigation*, the court came to this precise conclusion.[111] Although the defendant argued that the fraud-on-the-market theory merely presumes transaction causation, the court ruled that both transaction causation and loss causation are presumed if the misrepresentation or omission was material and was disseminated in a well-developed and open market.[112] The court noted that if the alleged harm was a result of the misstatement, "the fraud on the market theory

---

"transaction causation" is similar to the "but for" causation element of common-law fraud); Medline Industries, Inc. v. Blunt, Ellis & Loewi, Inc., No. 89 C 4851, 1993 U.S. Dist. LEXIS 581 at *40 (N.D. Ill. Jan. 20, 1993).

105. 485 U.S. 224, 250 (1988) (finding that "[i]t is not inappropriate to apply a presumption of reliance supported by the fraud-on-the-market theory.").

106. *Id.* at 247.

107. *Id.* In *Basic*, the Court noted that "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business." *Id.* at 241–42 (quoting Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986)).

108. *See id.* at 247. Although the opinion incorporates references to pecuniary harm, it does not specifically identify the proper measure of damages in fraud-on-the-market cases. In fact, Justice White recognized that a proper measure of damages is essential for "proper implementation of the fraud-on-the-market presumption." *Id.* at 254 n.5 (White, J., dissenting).

109. *Id.* at 247 (majority opinion).

110. *See id.*

111. *See* 738 F. Supp. 825, 835 (D. Del. 1990).

112. *Id.* (citing *Peil*, 806 F.2d 1154).

operates to relax the distinctions of the traditional concepts of reliance, materiality and causation, thereby reducing the evidentiary burden on the Rule 10b-5 plaintiff who has traded in an open and impersonal market."[113]

As the district court's interpretation of loss causation demonstrates, the treatment of loss causation in fraud-on-the-market cases has been anything but clear. Nevertheless, the Supreme Court sanctioned a presumption of reliance for fraud-on-the-market cases in *Basic*, although it made no specific mention of loss causation or transaction causation.[114] Unfortunately, the Supreme Court's approval of presumed reliance encouraged securities litigation by lowering the burden of proof.[115] To remedy this flood of litigation, Congress passed the Public Securities Litigation Reform Act, raising the pleading standard and proof requirements for securities class actions under Rule 10b-5.[116]

IV. ATTEMPTS TO LIMIT "STRIKE SUITS"[117] AND THE FAILURE OF THE PSLRA

The Supreme Court had long recognized that securities litigation entails the "threat of extensive discovery and disruption of normal business activities" for the target corporation.[118] That disruption of normal business can have profound economic consequences for a business defending itself in a 10b-5 class action. In fact, the very nature of private securities class actions produces overwhelming incentives to avoid trial.[119] Because of these incentives, many securities actions have potential settlement value for the plaintiffs' class "far out of proportion to their merit."[120] In addition, because nearly all class actions that are not dis-

113. *Id.*

114. *Id.* at 250.

115. *See* Nina Schuyler, *A Matter of Perception: Securities Litigation Skyrockets in Federal Courts*, COUNS. TO COUNS., Nov. 2004, at 16, 18, *available at* http://www.martindale.com/pdf/c2c/magazine/2004_Nov/C2CMag_Nov04Pulse.pdf.

116. *Id.*

117. A "strike suit" is an action that is brought "not to redress real [corporate] wrongs, but to realize upon their nuisance value" through settlement. Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541, 548 (1949).

118. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742–43 (1975).

119. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 528 (1991) (explaining that the substantive and procedural rules, the relationships among the parties, the lawyers on both sides, and the insurance carriers all encourage settlement of 10b-5 actions).

120. Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2063–64 (1995).

missed upon motion are settled, a plaintiff must only survive a motion to dismiss to reap tremendous financial rewards.[121]

The essential problem with these so-called "strike suits" is that they tend to enrich plaintiffs' attorneys more than they provide remuneration for shareholders who have been harmed.[122] With these considerations in mind, courts have attempted to curtail meritless complaints while still allowing bona fide claims to proceed.[123] Most courts, however, have been unable to strike a balance between the interests of aggrieved shareholders and the interests of the judiciary in limiting these unfounded "strike suits."[124]

Because a private action under Rule 10b-5 is essentially a claim of fraud, Rule 9(b) of the Federal Rules of Civil Procedure requires a plaintiff to plead the circumstances of the fraud with particularity.[125] And by the mid 1990's, courts had begun to rely on Rule 9(b) "to screen out non-meritorious and inadequately researched class action complaints."[126] Although this approach was effective in screening out some baseless actions, courts recognized that Congress was a more appropriate body for addressing the danger of "strike suits."[127] In 1995, Congress codified pleading requirements for securities claims and the common law elements of securities fraud in the PSLRA.[128] Although the PSLRA raised the pleadings bar by requiring that plaintiffs state with particularity "each statement alleged to have been misleading" and "facts giving rise to a strong inference" of scienter, the number of Rule 10b-5 class actions increased by nearly twenty percent in the six years following passage of

121. *See id.* at 2064.

122. *See* Natasha, Inc. v. Evita Marine Charters, Inc., 763 F.2d 468, 471 (1st Cir. 1985) (finding that a legal system where each party pays its own costs "may encourage plaintiffs to bring 'strike suits'—suits that have no legal merit but which a plaintiff hopes the defendant will settle by paying the plaintiff something less than what it would cost to defend the suit" (citations omitted)); Alexander, *supra* note 119, at 541 (suggesting that courts tend to award plaintiffs' attorneys a standard percentage fee based on the ultimate settlement figures, typically between 25% and 30%).

123. *See* ZVI Trading Corp. Employees' Money Purchase Pension Plan & Trust v. Ross (*In re* Time Warner Sec. Litig.), 9 F.3d 259, 263–64 (2d Cir. 1993). The court noted that there is an "interest in deterring the use of the litigation process as a device for extracting undeserved settlements." *Id.* at 263. However, "[i]t has never been clear how these competing interests are to be accommodated, and the adjudication process is not well suited to the formulation of a universal resolution." *Id.* Furthermore, the court recognized that "[i]n the absence of a more refined statutory standard . . . or a more detailed attempt at rule-making . . . courts must adjudicate the precise cases before them, striking the balance as best they can." *Id.* at 263–64.

124. *See, e.g., id.* at 264.

125. FED. R. CIV. P. 9 ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.").

126. Weiss & Beckerman, *supra* note 120, at 2064.

127. *See In re Time Warner*, 9 F.3d at 263.

128. 15 U.S.C. § 78u-4(b)(1), (2) (2000).

the Act.[129] Moreover, cunning plaintiffs' attorneys began to bring 10b-5 class actions in state court, hoping to avoid the federal forum and the PSLRA's strict pleading standards altogether.[130] Therefore, despite congressional intent, the new pleading requirements appeared to be ineffective in controlling "the sort of lawyer-driven machinations the PSLRA was designed to prevent."[131] Recognizing this failure, many courts utilized loss causation as an effective way to distinguish legitimate claims from those with little evidentiary basis.[132]

A. Two Approaches to Loss Causation

Because the PSLRA was relatively ineffective in limiting the number and incidence of Rule 10b-5 actions, loss causation emerged as an effective tool for courts hoping to screen out meritless claims. However, because the PSLRA does not explicitly state that a plaintiff must *plead* loss causation with particularity, circuit courts were divided as to what a private plaintiff must allege in his complaint in order to survive a motion to dismiss.[133] The Ninth and Third Circuits were of the opinion that a plaintiff need only plead that the misstatement somehow "touched upon" or "artificially inflated" the value of the security at the time of purchase.[134] Under this expansive view of loss causation, a plaintiff would only need to allege that the price of the security was artificially inflated at the time of purchase due to the omissions or misstatements. And because the plaintiff paid more for the security than he would have without the misrepresentations, the plaintiff was harmed because he purchased the security.

---

129. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 930.

130. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1511 (2006). Because claimants were bringing federal securities cases in state courts, Congress decided to pass the Securities Litigation Uniform Standards Act of 1998 (SLUSA). The Act provides that "[n]o covered class action" based on state law and alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" may be maintained "in any State or Federal court by any private party." 15 U.S.C. § 78bb(f)(1)–(f)(1)(A) (2000).

131. *In re* BankAmerica Corp. Sec. Litig., 95 F. Supp. 2d 1044, 1050 (E.D. Mo. 2000).

132. *See* Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447–48 (11th Cir. 1997); Rozanski v. Fleet Bank of New York, No. 96-7906, 1997 U.S. App. LEXIS 6735, at *6 (2d Cir. Apr. 9, 1997).

133. In fact, a number of early courts were unsure whether loss causation and transaction causation were separate elements of a Rule 10b-5 violation. *See, e.g.*, Shores v. Sklar, 647 F.2d 462, 469 (5th Cir. 1981).

134. *See* McGonigle v. Combs, 968 F.2d 810, 820–21 (9th Cir. 1992); Peil v. Speiser, 806 F.2d 1154, 1161–62 (3d Cir. 1986).

In contrast to the expansive view, the narrow view of loss causation requires that a plaintiff plead a more substantial connection between the misrepresentation and the economic loss.[135] Following this view, some circuits have required some sort of proximate relationship between the alleged misconduct and the pecuniary harm suffered by the investor.[136] For example, the Second Circuit's narrow view requires that the loss causation nexus be a "foreseeable consequence of any misrepresentation or material omission."[137] Although there is no clear standard for the narrow view of loss causation, a number of circuit courts have adopted some variation of it.[138] Moreover, while the Supreme Court has not determined how strong the connection between the misrepresentation and subsequent loss must be, it has emphatically rejected the Ninth Circuit's expansive view of loss causation in favor of some sort of "proximate" cause standard.[139]

B. The Supreme Court's Adoption of the Narrow View of Loss Causation

The Supreme Court rejected an expansive view of loss causation in *Dura Pharmaceuticals v. Broudo*, instead requiring a more substantial link between the misrepresentation and subsequent loss.[140] In *Dura*, private investors who purchased Dura Pharmaceuticals ("Dura") stock brought a securities class action against Dura and some of its managers.[141] The complaint alleged that the company—and its officers and directors—made false statements concerning the firm's financial condition and future FDA approval of newly developed medical devices.[142] Most importantly, the complaint alleged that the plaintiffs paid "artificially inflated prices" for the stock "in reliance on the integrity of the market."[143] The complaint further alleged that the artificially inflated purchase price thereby caused the plaintiffs' economic harm.[144] The Ninth Circuit ar-

135. *See* Emergent Capital Inv. Mgmt., LLC. v. Stonepath Group, Inc., 343 F.3d 189, 197 (2d Cir. 2003).
136. *See, e.g., Robbins*, 116 F.3d at 1447.
137. *Emergent Capital Inv. Mgmt.*, 343 F.3d at 197 (quoting Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 186 (2d Cir. 2001)).
138. *See, e.g., id.* at 197; Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000); *Robbins*, 116 F.3d at 1447; Bastian v. Petren Res. Corp., 892 F.2d 680, 684–86 (7th Cir. 1990).
139. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342 (2005).
140. *Id.*
141. *Id.* at 339.
142. *Id.*
143. *Id.* at 339–40.
144. *Id.* at 340.

ticulated that a plaintiff adequately pleads loss causation when "the price at the time of purchase [is] overstated" and there is "sufficient identification of the cause."[145] Moreover, the court held that "*loss causation* does not require pleading a stock price drop following a corrective disclosure or otherwise" because "the injury occurs at the time of the transaction."[146] Accordingly, the court noted that "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred."[147]

While this expansive view of loss causation appears to satisfy the PSLRA, it was rejected by the Supreme Court.[148] The Supreme Court assumed that "at the moment the transaction takes place, the plaintiff has suffered no loss" because "the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value."[149] Moreover, the Court reasoned that if "the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss."[150] While the Court acknowledged that "an initially inflated purchase price might mean a later loss," it stated that such a result is far from inevitable.[151] Following this reasoning, the Court suggested that any loss suffered by the plaintiff on the transaction "may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that [sic] lower price."[152] Therefore, the Court held that "the longer the time between purchase and sale . . . the more likely that other factors caused the loss."[153]

Unfortunately, the Court's reasoning did not explicitly state how strong the connection between the misrepresentation and the subsequent loss must be. Instead, the Court merely rejected the Ninth Circuit's expansive view of loss causation, finding that an "inflated purchase price will not itself . . . proximately cause the relevant economic loss."[154] The

145. Broudo v. Dura Pharm., Inc., 339 F.3d 933, 938 (9th Cir. 2003).
146. *Id.* (emphasis added).
147. *Id.*
148. *Dura*, 544 U.S. at 342–46.
149. *Id.* at 342 (emphasis omitted). It is difficult to understand this reasoning if the true value of the stock is below the market price. This interpretation would require the plaintiff to sell an artificially overvalued stock to a third party, passing the artificially inflated price, and subsequent loss—if any—on to that party. Theoretically, the third party would then have a cause of action against the defendant, abolishing the Supreme Court's unlikely attempt at loss limitation.
150. *Id.* (emphasis omitted).
151. *Id.*
152. *Id.* at 343.
153. *Id.*
154. *Id.* at 342 ("[I]n cases such as this one (*i.e.*, fraud-on-the-market cases), an inflated

Supreme Court, however, was careful to explicitly reject the "touches upon" standard for loss causation proposed by the Ninth Circuit.[155] The "touches upon" language adopted by the Ninth Circuit is particularly forgiving because it allows a plaintiff to recover even if the misconduct is a relatively insignificant factor in the subsequent drop in share price. The Court emphasized the inherent flaw in the Ninth Circuit's reasoning: "to 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires."[156] Whether the Court adopted a true "proximate" view of loss causation, similar to that of the Second Circuit, is less certain. Such an interpretation would be supported by the Court's holding, which requires that "a plaintiff prove that the defendant's misrepresentation . . . *proximately* caused the plaintiff's economic loss."[157]

In *Dura*, the Court also analyzed the PSLRA's stringent pleading requirements for plaintiffs in private securities actions under Rule 10b-5.[158] The Court confirmed that a plaintiff must plead with specificity "each misleading statement" and "facts giving rise to a strong inference that the defendant acted with the required state of mind."[159] In addition, the Court recognized that "the statute expressly imposes on plaintiffs 'the burden of proving' that the defendant's misrepresentations 'caused the loss for which the plaintiff seeks to recover.'"[160] From this language, the Court concluded that Congress intended to permit recovery for private securities fraud actions only if "plaintiffs adequately *allege and prove* the traditional elements of causation and loss."[161] By stating that a private plaintiff must "allege and prove" loss causation, the Court altered the plain language of the PSLRA, which states that the plaintiff has the "*burden of proving*" that the defendant's conduct "caused the loss for which the plaintiff seeks to recover."[162] By requiring a particular showing of loss causation at the pleading stage, the Court imposed a much greater obstacle for private plaintiffs in Rule 10b-5 actions.

However, the Court did not explain why a plaintiff is required to specifically plead loss causation when Congress explicitly posed no such obligation in the PSLRA.[163] The statute authorizes dismissal for failure to state a cause of action *only* when the complaint fails to specify the

---

purchase price will not itself constitute or proximately cause the relevant economic loss.").

155. *Id.* at 343.

156. *Id.*

157. *Id.* at 346 (emphasis added).

158. *Id.* at 345–46.

159. *Id.* at 345 (quoting 15 U.S.C. § 78u-4(b)(1), (2) (2000)).

160. *Id.* at 345–46 (quoting § 78u-4(b)(4)).

161. *Id.* at 346 (emphasis added).

162. 15 U.S.C. § 78u-4(b)(4) (emphasis added).

163. *See id.* § 78u-4. Inclusio unius est exclusio alterius.

misleading statements or when the complaint does not state specific facts that strongly aver scienter.[164] The Act merely acknowledges that loss causation is an element of the claim that the plaintiff must eventually prove at trial.[165] Based on the language in *Dura*, the Court was concerned about the prevalence of "strike suits" and the ineffectiveness of the PSLRA to curb such abuses.[166] However, by simply including loss causation as a pleading requirement in securities fraud cases without any explanation of the necessary causal connection, the Supreme Court has further complicated the state of the law.

The need for loss causation at the pleading stage is best explained by the nature of securities class actions in relation to the PSLRA. Paragraph (b) (4) of the Act requires the plaintiff to prove loss causation at the trial level.[167] However, nearly every Rule 10b-5 action that survives a motion to dismiss or motion for summary judgment is settled.[168] Therefore, such proof would almost never be required because of the high likelihood of settlement. Consequently, the PSLRA contains a fatal flaw in its requirement of loss causation. The Supreme Court may have recognized this flaw, deciding that Congress clearly contemplated a showing of loss causation before allowing recovery under the Rule. Thus, the only way to give effect to this congressional intent is to require a strong showing of loss causation at the pleading stage.

To be sure, the Court conceded that "neither the Rules nor the securities statutes impose any special further requirement in respect to the pleading of proximate causation or economic loss."[169] Nevertheless, the Court rejected the Ninth Circuit's expansive view of loss causation, finding that a plaintiff must allege more than that the misrepresentation "touches upon" the economic loss.[170] Instead, the Court noted that the complaint "must provide the defendant with 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.'"[171] The Court suggested that "allowing a plaintiff to forgo giving any indication of the economic loss and proximate cause [of that loss] would bring about harm

164. *Id.* § 78u-4(b)(3)(A).
165. *Id.* § 78u-4(b)(4).
166. *See Dura*, 544 U.S. at 347 (noting that the Ninth Circuit's standard "would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence.'" (quoting Blue Chip Stamps v. Manor Drug Stores, 42 U.S. 723 (1975)) (alteration in original)).
167. *Id.* at 345–46.
168. Weiss & Beckerman, *supra* note 120, at 2064.
169. *Dura*, 544 U.S. at 346.
170. *Id.*
171. *Id.* (quoting Conley v. Gibson, 355 U.S. 41, 47 (1957)).

of the very sort the statutes seek to avoid."[172] The Court also emphasized that the additional requirement of loss causation at the pleading stage would largely limit "groundless claim[s]" that merely "take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value" of the action.[173]

C. An Uncertain Standard

As noted above, the *Dura* Court concluded that only a strong proximate relationship can establish loss causation.[174] However, the Court's adoption of a proximate cause standard is troubling given the complexities and subjective nature of the doctrine. Furthermore, proximate causation is generally a matter of state law and can vary greatly from jurisdiction to jurisdiction. For example, the Ninth Circuit's proximate causation standard is satisfied if "the misrepresentation is *one substantial cause* of the investment's decline in value."[175] On the other hand, the Second Circuit has held that "proximate causation" means that "the damages suffered by [a] plaintiff must be *a foreseeable consequence* of any misrepresentation or material omission."[176] The Second Circuit's test also measures "how directly the subject of the fraudulent statement caused the loss."[177] Furthermore, this rigorous proximate causation standard requires a court to determine if "*intervening causes* are present," and to take into account "*the lapse of time* between the fraudulent statement and the loss."[178] Moreover, the Second Circuit's proximate causation standard "presents a *public policy question*, the resolution of which is predicated upon notions of equity because it establishes who, if anyone, along the causal chain should be liable for the plaintiffs' losses."[179] Put another way, the Second Circuit's test "must satisfy the judicial mind that such result conforms to 'a rough sense of justice.'"[180]

---

172. *Id.* at 347 (quoting H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.) (criticizing "abusive" practices including "the routine filing of lawsuits . . . with only [a] faint hope that the discovery process might lead eventually to some plausible cause of action")).

173. *Id.* (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975)).

174. *Id.* at 345–46.

175. Sparling v. Daou (*In re* Daou Sys., Inc.), 411 F.3d 1006, 1025 (9th Cir. 2005) (quoting Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 n.5 (11th Cir. 1997) (emphasis added)).

176. Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 186 (2d Cir. 2001) (emphasis added).

177. Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 96 (2d Cir. 2001).

178. *Id.* (emphasis added).

179. *Id.* (emphasis added).

180. *Id.* (quoting Palsgraf v. L.I.R.R. Co., 162 N.E. 99, 103 (1928) (Andrews, J., dissenting)).

Unfortunately, "proximate causation" does not explain the loss causation requirement because it does not specify how strong the causal requirement must be under Rule 10b-5. As noted above, the Second Circuit's interpretation of proximate cause is especially stringent, contemplating elements of foreseeability, intervening events, lapse of time, and a "rough sense of justice."[181] Conversely, the Ninth Circuit's proximate causation test appears to be relatively undemanding, requiring only that the misrepresentation be a "substantial cause" in the subsequent economic harm.[182] While the new "substantial cause" test appears to be more rigorous than the Ninth Circuit's prior "touches upon" standard for 10b-5 actions, there still appears to be considerable grey area between the Ninth Circuit's "substantial factor" standard and the Second Circuit's "foreseeability" test. Therefore, the debate over the magnitude of the causal link necessary to plead and prove loss causation will likely continue despite the Supreme Court's holding in *Dura*.

V. THE REVENGE OF THE NINTH CIRCUIT

Most courts have recognized the new pleading requirements outlined in *Dura*, adopting some form of proximate causation standard.[183] Perhaps the most interesting developments have come from the Ninth Circuit's response to the *Dura* opinion. In *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*,[184] the Ninth Circuit heard a 10b-5 action based on the sale of stock in a private placement.[185] In that case, the defendant allegedly misrepresented his financial condition prior to the plaintiff's purchase of the stock.[186] The defendant eventually went bankrupt and the plaintiff lost the entire value of its investment as a result of this misrepresentation.[187] The plaintiff asserted that it purchased the securities at artificially inflated prices and that the defendant's misrepresentation caused the loss it sustained.[188] The court determined that the Supreme Court's reasoning in *Dura* did not apply in the sale of private securities

181. *Id.*
182. *In re* Daou Sys., Inc., 411 F.3d 1006, 1025 (9th Cir. 2005).
183. *See* Amron v. Morgan Stanley Inv. Advisors, Inc., 464 F.3d 338 (2d Cir. 2006); Glaser v. Enzo Biochem, Inc., 464 F.3d 474 (4th Cir. 2006) (requiring a drop in stock price following corrective disclosure); United States v. Olis, 429 F.3d 540, 546 (5th Cir. 2005) (requiring corrective disclosure causing later decline in price); D.E. & J. Ltd. P'ship v. Conaway, 133 F. App'x 994, 1000-1001 (6th Cir. 2005) (rejecting loss causation claim that stock price was artificially inflated at the time of purchase).
184. 416 F.3d 940 (9th Cir. 2005).
185. *Id.* at 944–45.
186. *Id.* at 947.
187. *Id.* at 949.
188. *Id.* at 949 n.2.

because the plaintiff was not relying on the fraud-on-the-market theory of presumed reliance.[189] Rather, the plaintiff claimed that it actually relied on the defendant's assurances and was in privity with the defendant.[190] Under such circumstances, the Ninth Circuit determined that the plaintiff met its pleading requirements and that *Dura* was not controlling.[191]

Although somewhat counter to *Dura*, this interpretation has merit. Because the case did not involve a class action suit, the PSLRA was not implicated. Moreover, there was no presumption of transaction causation—or reliance—because of the privity between the plaintiff and defendant. Therefore, many of the evidentiary rationales cited in *Dura* for imposing a stringent loss causation requirement were not present. Thus, under the *Livid Holdings* reasoning, it is likely that the loss causation requirement in *Dura* does not apply to securities actions where the parties are in privity with one another.[192]

The Ninth Circuit has also crafted a new standard with respect to loss causation. In *In re Daou Systems, Inc.*, the Ninth Circuit held that a plaintiff "is not required to show 'that a misrepresentation was the *sole* reason for the investment's decline in value' in order to establish loss causation."[193] Instead, the court determined that a plaintiff must show only that "the misrepresentation is *one substantial cause* of the investment's decline in value."[194] The court further reasoned that "'other contributing forces will not bar recovery under the loss causation requirement' but will play a role 'in determining recoverable damages.'"[195] In *Dura*, the Supreme Court held that a misrepresentation that merely "touches upon" a later loss is insufficient to establish loss causation as a matter of law.[196] But the Court did not determine how strong of a link must exist between the misrepresentation and the later loss. Essentially, the Ninth Circuit's holding in *In re Daou Sysems, Inc.* establishes that the plaintiff need only allege that the misrepresentation "is *one substantial*

189. *Id.*
190. *Id.*
191. *Id.*
192. Theoretically, there is no reason to require transaction causation in this kind of action either. Whether or not the plaintiff relied on a misrepresentation does not negate the loss. If scienter and materiality are satisfied, there is no good reason not to subject a defendant to liability. The case is essentially turned into a "practice" or "scheme" action, which would not require reliance either. 17 C.F.R. § 240.10b-5 (2005).
193. 411 F.3d 1006, 1025 (9th Cir. 2005) (quoting Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 n.5 (11th Cir. 1997)).
194. *Id.* (quoting *Robbins* at 1447 n.5) (emphasis added).
195. *Id.* (quoting *Robbins* at 1447 n.5).
196. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 343 (2005).

cause" in the decline in value of the security.[197] Once the plaintiff satisfies this standard, his complaint will survive dismissal and the case can go to trial. Only when calculating damages will the extent of the causation come into play under the Ninth Circuit's rule. A number of other courts have determined that proximate cause is established when the misconduct is a "substantial factor" of the alleged harm.[198] Although less rigorous, this standard appears to be more workable than the Second Circuit's "foreseeability" and "rough sense of justice" test for loss causation.

However, it is difficult to understand how the "substantial factor" test is any different than the "touches upon" standard rejected by the Supreme Court. For example, if a defendant's misrepresentation artificially inflated the price of the stock, it is reasonable to assume that the misrepresentation was a "substantial factor" in a purchaser's economic loss due to any subsequent decline in stock price. Furthermore, the "substantial factor" test appears to be a question of fact, ill-suited for resolution at the pleading stage. Finally, the Ninth Circuit's new test postpones the determination of the causal connection between the misrepresentation and the later loss until the damages phase of a suit. If postponed in this manner, such a determination will seldom come into play because these cases rarely reach the damages phase. Therefore, the Ninth Circuit's new standard will not provide protection for corporate defendants hoping to escape Rule 10b-5 liability.

VI. THE NEW STANDARD FOR LOSS CAUSATION

As discussed above, the Supreme Court definitively rejected the Ninth Circuit's "touches upon" standard for loss causation.[199] Furthermore, the Court clearly adopted a proximate causation standard, expressly holding that a plaintiff must show that the defendant "proximately" caused his economic harm.[200] However, the Court did not expressly state what standard of proximate cause satisfies the loss causation requirement. Nevertheless, the Court's language bears a striking resemblance to the Second Circuit's interpretation of loss causation. The Court specifically stated that that "the longer the time between purchase and sale . . . the more likely that other factors caused the loss."[201] Fur-

197. *In re* Daou Sys., Inc., 411 F.3d 1006, 1025 (9th Cir. 2005) (emphasis added).

198. *See* Tetro v. Town of Stratford, 458 A.2d 5, 7 (Conn. 1983); Haynes v. Hamilton County, 883 S.W.2d 606, 612 (Tenn. 1994).

199. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 343 (2005) ("To 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires.").

200. *Id.* at 346.

201. *Id.* at 343.

thermore, the Court noted that loss causation is lacking if "other events, which taken separately or together account for some or all of that lower price."[202] Similarly, the Second Circuit's loss causation analysis requires a court to determine if "intervening causes are present," and to take into account "the lapse of time between the fraudulent statement and the loss."[203] This test also measures "how directly the subject of the fraudulent statement caused the loss."[204] Based on this similarity, it is likely that the Supreme Court was persuaded by the Second Circuit's view of loss causation.[205]

To be sure, the Court explained that if other factors caused or contributed to the plaintiff's economic loss, then loss causation has not been satisfied.[206] However, the Court did not explain how many other factors are necessary before the causal link is severed. The answer to this question probably involves a proximate cause analysis informed by the facts of each case. In addition, the Court noted the importance of using loss causation as a tool for limiting the prevalence of strike suits.[207] This mandate should be the foundation upon which the proximate cause model is built. If a loss causation framework does not effectively screen meritless suits, it has little judicial value.

Finally, it is important to remember that nearly every Rule 10b-5 claim that survives dismissal will be settled.[208] Most Rule 10b-5 cases are decided on the pleadings and should be treated as such. Therefore, plaintiffs should be prepared to show a substantial relationship between the alleged conduct and economic loss in their complaint. Judges, on the other hand, should be willing to dismiss a case if a strong loss causal nexus is lacking.

VII. A BETTER STANDARD FOR LOSS CAUSATION

Although the Court's holding establishes a proximate cause analysis to show loss causation, such an approach is probably inadequate. For example, the Supreme Court held that a plaintiff must establish both

202. *Id.*

203. Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 96 (2d Cir. 2001).

204. *Id.*

205. Interestingly, the Court did not directly cite the Second Circuit in its opinion, even though its language is conspicuously similar.

206. *Dura*, 544 U.S. at 343.

207. *Id.* at 347 (quoting H. R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.) (criticizing "abusive" practices including "the routine filing of lawsuits . . . with only [a] faint hope that the discovery process might lead eventually to some plausible cause of action")).

208. Weiss & Beckerman, *supra* note 120, at 2064.

transaction causation and loss causation to recover under Rule 10b-5.[209] However, reliance—or transaction causation—is presumed in misrepresentation cases involving publicly traded securities.[210] Unfortunately, courts tend to speak of transaction causation as the "but for" causal element, and loss causation as the "proximate" causal element of a 10b-5 claim.[211] And because "transaction causation" is presumed in publicly traded securities cases, it is reasonable to assume that "but for" or "cause-in-fact" causation is also presumed.[212] Moreover, the Supreme Court's recurring use of the term "proximate" and "proximately" to describe loss causation gives the impression that the element is equivalent only to the legal cause of the economic harm.[213] However, this interpretation would be a misunderstanding of the law. Transaction causation merely requires that the initial transaction was induced by the misrepresentation.[214] It has no bearing on the "but for" or "cause-in-fact" of the plaintiff's ultimate loss. Therefore, a plaintiff must still establish that the misrepresentation was both the "but for" as well as the "proximate" cause of the economic loss.

A better standard would incorporate both *cause in fact* and *proximate cause* into the loss causation analysis. Under this framework, a plaintiff would need to establish that the misrepresentation was the "but for" cause of her loss, as well as the "proximate" cause of her loss. This standard would require a plaintiff to adequately plead the causal connection between the economic harm and the misrepresentation. This standard would also eliminate transaction causation altogether, reducing the association of "but for" causation with that element.[215] Finally, a complete proximate cause and cause in fact analysis would require a plaintiff to provide a detailed explanation of the causal link between the misrepre-

209. *Dura*, 544 U.S. at 341.

210. *Id.*

211. Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 186 (2d Cir. 2001); Trident Inv. Mgmt., Inc. v. Amoco Oil Co., 194 F.3d 772, 778 (7th Cir. 1999); Medline Industries, Inc. v. Blunt, Ellis & Loewi, Inc., No. 89 C 4851, 1993 U.S. Dist. LEXIS 581 at *40 (N.D. Ill. Jan. 20, 1993).

212. *Compare In re* Phillips Petroleum Sec. Litigation, 738 F. Supp. 825, 835 (D. Del. 1990) (finding that the Third Circuit presumes "both transaction causation and loss causation"), *with* Nathenson v. Zonagen, Inc, (*In re* Zonagen Sec. Litig.), 257 F.3d 171, 186 (2d Cir. 2001) (finding that stock price was inflated when plaintiff purchased it, however, inflation alone is not sufficient to demonstrate loss causation).

213. *Dura*, 544 U.S. at 346.

214. *See* Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988).

215. Transaction causation serves little or no substantive or procedural purpose in 10b-5 class actions. And because reliance is presumed in cases involving public securities, it cannot screen out meritless strike suits. Additionally, there is no sound reason for requiring transaction causation as an element in any securities fraud case. Instead, it should come into play only as evidence—or lack thereof—of loss causation.

sentation and the subsequent harm. This additional disclosure would further safeguard against vexatious "strike suits," and provide the trial judge with sufficient information to make an informed decision on the pleadings.

CONCLUSION

Although the Supreme Court has firmly established that a private plaintiff in a securities fraud action must allege and prove loss causation, it has not provided much guidance as to the required causal connection. Based on the language of the opinion, the Supreme Court endorsed some sort of proximate relationship between the misrepresentation and the subsequent economic loss. Whether this connection requires a "foreseeable" element to satisfy loss causation is unclear. The Court did suggest that the plaintiff must suffer a net loss on his investment, sell his shares relatively close in time to the misrepresentation, and show that the misconduct was a substantial, perhaps even predominant factor in the subsequent loss in value. In addition, the Court suggested that a motivating factor in requiring a proximate relationship was to provide a check on the prevalence of strike suits filed solely for their settlement value.[216] Whether these elements are incorporated into the loss causation standard by other courts is yet to be determined.

A better approach to causation in 10b-5 cases would be to eliminate reliance altogether. This approach would entail including both a *proximate* and a *but for* causation requirement in the loss causation analysis. It also would involve increased information at the pleading stage, requiring a detailed explanation of the causal connection between the misrepresentation or omission and the plaintiff's economic loss. Therefore, this approach would simplify and clarify causation, and would provide a meaningful tool for screening out meritless 10b-5 class actions.

216. *Dura*, 544 U.S. at 347.