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News

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Loss Causation Pleading Standard

Jacqueline Sailer and Brian P. Murray

There is no heightened **pleading** requirement for **loss causation** under the Private Securities Litigation Reform Act of 1995 (PSLRA); nonetheless, courts are grappling with the issue of what suffices to **plead loss causation** under the notice-**pleading** requirements.¹

Ideally, this **standard** would hinge on the inflation at the time of purchase, regardless of whether the subsequent drop in stock price related to the misrepresentation or omission alleged. A plaintiff should have to allege simply that the fraud caused her to overpay for a security and she was unable to recover the overpayment.²

Loss causation is determined through a proximate cause analysis, i.e., whether the loss was a foreseeable consequence of the fraud. As with proximate cause in a tort case, loss causation is not capable of a rigid formulation. Rather, it involves a case-by-case inquiry with two basic components: did the fraud cause the plaintiff to overpay for the security and did overpaying for the security ultimately cause a loss?³

At Time of Purchase

In a case currently pending in the U.S. Supreme Court, the U.S. Court of Appeals for the Ninth Circuit held that for pleading purposes, it should suffice that the misrepresentation inflated the price of the security at the time of the purchase.⁴ This is because, as the U.S. Court of Appeals for the Second Circuit has held, the issue is whether the damages are a foreseeable consequence of the misrepresentation.⁵ While uncomplicated in theory, the issue is not easily resolved because of the widely divergent interpretations of the meaning of "cause."⁶

Above all, **loss causation** in securities cases requires malleability. Thus, the ideal **pleading standard** for **loss causation** is one that has application in most of the scenarios that arise in securities fraud cases. An approach that perhaps best

captures the requisite malleability is described in a concurring opinion by Judge Sneed in *Green v. Occidental Petroleum Corp.*⁷ Judge Sneed wrote that the market price (reflecting the fraudulent information) of a security and the "true value" (reflecting what the price would have been absent the fraud) must be ascertained. Plotting both lines on a graph will result in a band or "ribbon" between the two lines, which represents the fraudulent inflation, or "the effect of the corporate defendant's conduct."⁸ The ribbon may grow thicker (a divergence) or thinner (a convergence) depending on the value the market places on the misrepresentation.⁹ The cost of the false statements should be recovered "from the wrongdoer to the extent not recovered in the open market."¹⁰ Implicit here is that the value of the misrepresentation is either eliminated or diminished, through disclosure or otherwise.

Three Scenarios

Loss causation should not be tied to a drop upon disclosure. The reason for this is apparent upon review of three scenarios in which a fraudulently inflated stock will cause damage even absent such a drop.

1. If a Company Fails Completely, The Overpayment Is Not Recoverable In the Open Market. First, take the case of a company that makes a false statement which inflates a stock, whose true value is \$150, by \$25, to \$175, and then goes bankrupt for reasons unrelated to the fraud (an act of God, for instance). Here the plaintiff will have lost his entire \$175 investment. Of this \$175, while \$150 would have been lost regardless of the fraud, an extra \$25 was lost solely because the plaintiff paid \$25 too much due to the fraud. Here the true value line and price line converge at zero, and the plaintiff cannot recover his \$25 on the open market. It is thus a "foreseeable" consequence of the fraud that the plaintiff lost this extra \$25.¹¹ By contrast, the plaintiff's \$150 loss, which represented the true value of the company he was purchasing, is not a consequence of the fraud and thus not recoverable.¹²

A corollary of this example is when a misrepresentation inflates a stock from its true value of \$150 to \$175. Before disclosure, the stock drops to \$10 (due, perhaps, to a collapsed market bubble). At least \$15, and possibly all \$25, of the fraudulent inflation has been removed from the price of the stock,¹³ because the value of the false information has changed. In such circumstances, loss causation can be inferred.¹⁴

2. The Value Of The False Statement Can Decline Prior To Disclosure. Second, the value of the false statement may evaporate before disclosure, resulting in no decline in the price of the stock when the truth is revealed. Suppose a company makes a false statement about a product's efficiency. If the company ceases selling the product, the market will no longer place any value on the false statement and the true value line and price line will converge. Therefore, disclosure of the truth will work no downward pressure on the stock price since the market no

longer places value on the false statement.¹⁵ Here the true value upon disclosure equals market price, and the plaintiff cannot recover the extra \$25 of artificial inflation by selling the stock.¹⁶ Requiring a contemporaneous price drop with disclosure would result in these defrauded purchasers being left without a remedy despite their injury.¹⁷

The Third Circuit

The U.S. Court of Appeals for the Third Circuit recognized as much in *Semerenco v. Cendant Corp.*,¹⁸ stating that "[w]here the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation. In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price." The Third Circuit did not state the "correction" must occur contemporaneously with disclosure. As shown above, there need not be a drop associated with disclosure for the purchaser to not be able to recover the cost of the misrepresentation; there merely needs to be a "correction," as the Third Circuit puts it (or a convergence as others say), and this correction can occur prior to disclosure.¹⁹

The U.S. Court of Appeals for the Eleventh Circuit, in *Robbins v. Koger Props., Inc.*,²⁰ recognized that there may be situations where the value of the misrepresentation is removed during the class period. "Plaintiffs here offered no evidence of a connection between Deloitte's misrepresentations and the decline in price of KPI stock throughout the class period or following the October 1990 dividend cut" ending the class period.²¹ By phrasing the inquiry in the disjunctive, the Eleventh Circuit recognized that there need not be a drop upon disclosure, and the value of the misrepresentation can be lost in other ways during the class period.²²

3. Good News May Counteract The Disclosure. Finally, subsequent events and announcements may mask what would have been a drop upon disclosure. A company may release corrective news (a restatement of past results) simultaneously with good news ('we've struck oil'). The value of the good news may so outweigh the news correcting the misrepresentation or omission that the stock may maintain its price or rise. Here, the harm occurs because "a stock does not appreciate as it would have absent the fraudulent conduct."²³

Of course, any **loss causation** determination, which depends heavily on a factually developed record and expert testimony, cannot be made based on the **pleadings**.²⁴ A majority of the cases concerning **loss causation** are decisions at the summary judgment or trial phase of a case.

Conclusion

In sum, a **loss causation pleading standard** that ties the fraud to overpayment for

a security, which overpayment the plaintiff was unable to recover, without regard for any subsequent price drop, places the defendant sufficiently on notice of that element of the securities fraud claim and preserves meritorious claims that otherwise would be dismissed. Congress did not heighten the **pleading standard** for **loss causation** under the PSLRA; courts should avoid doing so as well. Particularly now, in this post-Enron world, courts should embrace the goals of shareholder protection and restitution embodied in the federal securities laws. A flexible **pleading standard** is consistent with those goals. Adopting an overly restrictive **pleading standard** for **loss causation** would preclude plaintiffs with otherwise meritorious claims from pursuing actions to recover their **losses** from those who caused the **loss**.

1. [15 USC §78u-4\(b\)\(4\)](#). A private plaintiff must prove at trial that "the act or omission ... caused the **loss** for which the plaintiff seeks to recover damages." [Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 96 \(2d Cir. 2001\)](#).
2. In keeping with the mandate that §10(b) "be read flexibly, not technically and restrictively and that [it] provide[] a cause of action for any plaintiff who suffer(s) any injury as a result of deceptive practices touching its sale [or purchase] of securities," [Santa Fe Indus. v. Green, 430 U.S. 462, 475- 76 \(1977\)](#) (internal quotations omitted), the **pleading standard** for **loss causation** "is straightforward. The plaintiff must allege that it was in fact injured by the misstatement or omission of which it complains." [Caremark, Inc. v. Coram Healthcare Corp., 113 F.3d 645, 649 \(7th Cir. 1997\)](#).
3. "We have often compared loss causation to the tort law concept of proximate cause ..." [Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 197 \(2d Cir. 2003\)](#); see [Miller v. Asensio & Co., 364 F.3d 223, 227 \(4th Cir. 2004\)](#); [In re Control Data Corp. Sec. Litig., 933 F. 2d 616, 619 \(8th Cir. 1991\)](#).
4. [Broudo v. Dura Pharm., 339 F.3d 933, 930 \(9th Cir. 2003\)](#), cert. granted, [124 S. Ct. 2904 \(2004\)](#). The Ninth Circuit's opinion in this case has fervent supporters. See Merritt B. Fox, Causation and Fraud on the Market, *NEW YORK LAW JOURNAL* (Sept. 14, 2004) ('The Ninth Circuit reached the substantively correct result in my view.').
5. See, e.g., [Emergent Capital, 343 F.3d at 197](#) (there must be a "causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.').
6. [AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 235 \(2d Cir. 2000\)](#) ('A major source of confusion in this regard is the use of causation language. ') (Winters, C.J., dissenting)
7. [541 F.2d 1335 \(9th Cir. 1976\)](#). While Judge Sneed in *Green* addressed the proper measure of damages, his analysis is applicable to loss causation as well. Loss

causation requires a showing that the defendant's conduct substantially caused the damages; the exact amount of damages solely caused by the misconduct is calculated in the subsequent damages inquiry. See [Miller](#), 364 F.3d at 229-30 ('[W]hen determining whether a plaintiff has demonstrated that a defendant proximately caused damages to establish Rule 10b-5 liability, courts look to whether the plaintiff has proved the fact that the defendant caused the damages, rather than the amount of recoverable damages.'). Both inquiries require an assessment of damages; "the proximately caused 'injury' necessary to prove liability [is indistinguishable from] the 'damages' necessary to recover a monetary award." [Id.](#) at 229.

8. [Id.](#) at 1344 (Sneed, J., concurring).

9. [Id.](#) at 1345 (Sneed, J., concurring). The ultimate convergence is when the true value and price line are the same, and there is no inflation due to the misrepresentation.

10. [Id.](#) at 1346 (Sneed, J., concurring).

11. See [AUSA Life Ins.](#), 206 F.3d at 235 ('[I]f a firm [does not survive] after an investor has been misled as to solvency, the investor should not be denied recovery on the ground that it was management's lack of skill rather than the false assurances of solvency that 'caused' the loss.').

12. [In re Wash. Public Power Supply Sys. Sec. Litig.](#), 650 F. Supp. 1346, 1354 (W.D. Wash. 1986) ('Properly applied, the concept of loss causation will permit the plaintiff to recover only that damage caused by the misrepresentation: the amount paid over the true value.');

[In re Blech Sec. Litig.](#), 961 F. Supp. 569, 586 (S.D.N.Y. 1997) (loss causation found where "economic harm to the Plaintiffs from the ultimate collapse of the price of the Blech securities that were inflated by the actions of [defendants] was a foreseeable consequence").

13. A stock selling for \$10 per share obviously cannot have \$25 of inflation.

14. [In re Initial Public Offering Sec. Litig. \['IPO'\]](#), Nos. 21-MC-92, 01-Civ-3857, 01-Civ-8404, 01-Civ-7048, 01-Civ-9417, 01-Civ-6001, 01-Civ-0242, 2004 U.S. Dist. LEXIS 20497, at *160-61 (S.D.N.Y. Oct. 13, 2004) (when stocks drop far below initial value and are close to zero, "loss causation may be inferred simply from the disappearance of the original inflation").

15. See [Retsky Family Ltd. P'ship v. Price Waterhouse LLP](#), No. 97-7694, 1998 WL 774678 (N.D. Ill. Oct. 21, 1998) (loss causation found although market correction occurred prior to 1997 disclosure of 1994-95 revenue overstatement, when value of stock at time of disclosure reflected 1996 revenues).

16. This example belies a typical defense argument that the inflation caused by the misrepresentation is not eliminated until the market learns of the misrepresentation either through a corrective disclosure by the company or otherwise. See

IPO, 297 F. Supp. 2d 668, 673 (S.D.N.Y. 2003) (if "the normal functioning of the securities market causes the inflationary effect to dissipate over time, a customer who buys and sells at inflated prices will still suffer a loss based on the inflated price at the time of purchase so long as the price was less inflated at the time of sale'); *In re Dynegy, Inc. Sec. Litig.*, No. Civ.A.H-02-1571, 2004 WL 2308799, at *46 (S.D. Tex. Oct. 7, 2004) (fact that losses were incurred prior to corrective disclosure does not break chain of loss causation).

17. "[T]here are clear cases of fraud where the stock declined substantially prior to the formal announcement of fraud." Jay W. Eisenhofer, Geoffrey C. Jarvis, and James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 BUS. LAW 1419, 1441 (2004).

18. 223 F.3d 165, 185 (3d Cir. 2000).

19. See *Swack v. Credit Suisse First Boston*, No. Civ. 02-11943-DPW, 2004 WL 2203482, at *14 (D. Mass. Sept. 21, 2004) (focusing on the "correction in the market price" language in *Semerenko* and interpreting it as consistent with the position that the loss in value need not come at the end of the class period upon disclosure). See also *The Roots P'ship v. Land's End, Inc.*, 965 F.2d 1411, 1419 (7th Cir. 1992) (inflation caused by prediction removed when actual results are announced).

20. 116 F.3d 1441 (11th Cir. 1997).

21. *Id.* at 1448 (emphasis added).

22. The Robbins court was even more explicit when it stated "there is no evidence that this price inflation was removed from the market price of KPI stock, causing plaintiffs a loss." *Id.* Presumably, had the plaintiffs shown at trial the inflation was removed from the price of the stock by the end of the class period, the jury verdict would have been upheld.

23. *Gebhardt v. Conagra Funds, Inc.*, 335 F.3d 824, 831-32 (8th Cir. 2003); see also *Swack*, 2004 WL 2203482, at *12 ('Stock prices rise and fall for combinations of many different reasons. Defendants' conduct could have tempered a drop in price that would otherwise have occurred, or resulted in a greater increase than the stock would otherwise have enjoyed ...').

24. *In re Warner Communications Sec. Litig.*, 618 F. Supp. 735, 744-45 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986) (establishing "true value" necessitates expert testimony); *Control Data*, 933 F.2d at 621 (determining whether misrepresentation inflated the price of a stock is a jury question). See also *Lawrence E. Jaffe Pension Plan v. Household Int'l*, No. 02C5893, 2004 WL 2108410, at *2 (N.D. Ill. Sept. 21, 2004) ('It is unreasonable for defendants to expect the exact damages formula from initial disclosures in a securities fraud action where expert

analysis is undoubtably necessary.').

Jacqueline Sailer and Brian P. Murray are partners at Murray, Frank & Sailer.

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