INSIGHTS
THE CORPORATE & SECURITIES LAW ADVISOR
Volume 18 Number 2, February 2004

SECURITIES LITIGATION

A Defendant's Guide to Loss Causation

Recent case law, especially the Emergent *decision in the Second Circuit, has reinforced the importance for defendants of attacking a securities fraud complaint on the ground that it fails to plead loss causation. Although the law on this subject remains in some disarray, a careful review of the existing precedents in most Circuits reveals that there are many opportunities to argue that, consistent with* Emergent*, it is not enough for a plaintiff to allege that he paid an artificially inflated price for the securities at issue.*

by Richard A. Rosen and Vanessa Richards

In order to pursue a Rule 10b-5 claim, a plaintiff must plead and prove both transaction causation and loss causation.[1] Although some recent decisions appear to have incorrectly merged the two concepts (a problem that is discussed in more depth subsequently) it is important to stress that they are distinct; it is quite common for a plaintiff to be capable of pleading and proving "transaction causation," while wholly failing to adequately plead or establish "loss causation."

Richard A. Rosen is a litigation partner and Chair of the Securities Litigation Practice Group at Paul, Weiss, Rifkind, Wharton and Garrison. Vanessa Richards is an associate at the firm. Both authors greatly appreciate the assistance of Scott Horlacher. This article is based on a paper submitted for the SIA Compliance and Legal Division Annual Seminar on March 23–26, 2004 in Scottsdale, AZ. Mr. Rosen represents a defendant in several of the matters discussed in this article.

Succinctly stated, "transaction causation" looks to why the plaintiff invested; "loss causation" asks why he lost the value of his investment. Put another way, establishing transaction causation, which has been equated to "but for" causation and reliance, requires proof that the alleged misstatements or omissions caused the plaintiff to engage in the transactions about which he now complains.[2] By contrast, loss causation, frequently analogized to the tort concept of proximate causation, "refers to a direct causal link between the misstatement and the claimant's economic loss,"[3] which "mean[s] that the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material omission."[4] The important question arises when one tries to *apply* this rather abstract concept—a subject over which the courts are seriously divided.

The distinction between transaction and loss causation is particularly important in light of the Private Securities Litigation Reform Act (PSLRA), which codifies the loss causation element of 10b-5 claims. By so doing, Congress sought to make it more difficult for plaintiffs to successfully plead securities fraud[5] in an effort to curb what it deemed to be abusive class action lawsuits against US companies.[6] To that end, the PSLRA requires that "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to have violated this chapter caused the loss for which the plaintiff seeks to recover damages."[7] However, this statutory language goes only so far; neither the text nor anything in the legislative history illuminates the practical question: What does the plaintiff actually have to plead and prove?[8]

Circuits Split on Loss Causation

The most common question courts now face with regard to loss causation is whether a plaintiff satisfies

this element of a 10b-5 claim simply by pleading and proving that the defendant's actions artificially inflated the value of the stock at issue. In answering this question, the circuits have split.

That Price Inflation Alone Is Insufficient

The Second Circuit, on one side of the spectrum, has rejected the contention that pleading artificial inflation of the market alone suffices to allege loss causation. The court most recently articulated its position in *Emergent Capital Inv. Mgmt. LLC v. Stonepath Group, Inc.*,[9] in which the plaintiff appealed from the dismissal of its complaint alleging that defendants' omissions regarding their current unscrupulous professional relationships and prior failed business ventures inflated the value of their company's stock, thereby causing plaintiff's loss. Specifically, plaintiff alleged that one defendant had "failed to disclose [his] history of failed investment projects undertaken with . . . an individual barred from the securities industry by the National Association of Securities Dealers."[10] Plaintiff contended that this omission "'induced a disparity between the price plaintiff paid for the [company's] shares and their true investment quality' at the time of purchase."[11]

A plaintiff must specify a "causal link between the alleged misconduct and the economic harm ultimately suffered by the [plaintiff]."

The court, however, concluded that the alleged omissions were insufficient to satisfy the loss causation requirement, holding that when pleading securities fraud, a plaintiff must specify a "causal link between the alleged misconduct and the economic harm ultimately suffered by the [plaintiff]."[12] Plaintiff's allegations were deficient, the court concluded, because the alleged omissions had nothing to do with "why [plaintiff] lost money on the purchase."[13]

Emergent does not stand alone,[14] nor did it represent a significant change in Second Circuit law, but rather an important clarification of a few prior somewhat murky precedents. Moreover, a number of courts from other circuits follow the same approach as *Emergent*.[15]

Despite this illuminating holding, however, recent decisions from the Southern District of New York indicate that some judges are resistant to applying a strict loss causation pleading requirement. For example, in *In re Initial Public Offering Securities Litigation*,[16] Judge Scheindlin, distinguishing *Emergent*, held that because "*Emergent Capital* is limited to material misstatement and omission cases" brought pursuant to Rule 10b-5(b) and the instant action alleged market manipulation under Rules 10b-5(a) and 10b-5(c), the Second Circuit holding is not applicable.[17] Judge Scheindlin reasoned that, unlike 10b-5(b) claims, claims of market manipulation involve "a discrete act that influences stock price. Once any manipulation ceases, however, the information available to the market is the same as before, and the stock price gradually returns to its true value."[18] Thus, "it may be permissible to infer that the artificial inflation will inevitably dissipate" in such cases.[19] For this reason, "plaintiffs' allegations of artificial inflation are sufficient to plead loss causation because it is fair to infer that the inflationary effect must inevitably diminish over time. It is that dissipation, and not the inflation itself, that causes plaintiffs' loss."[20]

If the Court had stopped after drawing this important distinction between 10b-5(b) and 10b-5(a) and 10b-5(c) claims, the case might have had very limited ongoing significance, inasmuch as there are good arguments that 10b-5(a) and 10b-5(c) apply to a relatively narrow range of fact patterns.[21] But, in a troubling and very brief section of her opinion, Judge Scheindlin bootstrapped as a means of maintaining plaintiffs' 10b-5(b) claims of material misstatements and omissions as well. Her conclusory reasoning was as follows:

> Emergent Capital requires allegations of a "causal connection between the content of the alleged misstatements and 'the harm actually suffered.'" The content of [defendants'] misstatements was, in essence: "this is a fair, efficient market, unaffected by manipulation." In fact (according to plaintiffs), the market was manipulated. For the reasons discussed in Part III.B above, that market manipulation was a cause of plaintiffs' loss. Therefore, the misstatements that concealed that manipulation also were a cause of plaintiffs' loss.[22]

Price Inflation May Be Sufficient

In stark contrast to the Second Circuit, the Eighth and Ninth Circuits have both held that "[t]he fraud-on-the-market theory . . . allow[s] the fact finder to presume that the stock's price reflected the inflated earnings, and it makes sense to conclude that the plaintiffs were harmed when they paid more for the stock than it was worth."[23] In *Gebhardt v. ConAgra Foods, Inc.*,[24] the plaintiff brought suit after a negligible decline in the stock price following defendant's disclosure that one of its subsidiaries had misrepresented its earnings. While this decline was soon after reversed, the court reasoned that "stockholders can be damaged in ways other than seeing their stocks decline. If a stock does not appreciate as it would have absent the fraudulent conduct, investors have suffered a harm."[25] On this basis, the court "decline[d] to attach dispositive significance to the stock's price movements absent sufficient facts and expert testimony, which cannot be considered at this procedural juncture, to put this information in its proper context."[26]

This case, however, is potentially distinguishable from many other situations sparking securities litigation. The stock at issue declined by roughly 4 percent the day after the company announced the earnings restatement at issue in the case, and it was on this basis that the court concluded that there "was a sufficient allegation of a causal link between the company's misbehavior and a subsequent decline, although it was a modest one."[27]

The Ninth Circuit, in a series of cases culminating in its recent decision in *Broudo v. Dura Pharmaceutical, Inc.*,[28] has long held that allegations of artificial inflation will suffice to adequately plead loss causation. The court reasons that "for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the transaction."[29] Thus, for the court, "[i]t is at that time that damages are to be measured."[30]

Loss Causation at the Summary Judgment and Trial Stages

It cannot be overemphasized that, even in those circuits that apply relatively liberal pleading requirements, courts nonetheless do not hesitate to enter judgment for the defense (including on summary judgment) when plaintiffs fail to actually *prove* loss causation.[31] Indeed, several courts are quite explicit in saying that, while a loss causation pleading may be sufficient for purposes of satisfying Rule 9(b) and the PSLRA, "defendants may be able to show *after discovery* that an unforeseeable intervening event caused the stock price to decline,"[32] thereby entitling them to summary judgment.

Specific Loss Causation Scenarios

Given that, all too often, discussions of pleading standards degenerate into invocation of arid abstract concepts and phrases. In order to get a more concrete sense of how loss causation issues really play out in the district courts, it is worth examining a few of the most commonly recurring fact patterns. Courts have held that a complaint alleging artificial inflation, and nothing more, will be dismissed if the plaintiff's loss resulted not from the defendant's misrepresentations or omissions, but from industry-wide catastrophic events, such as the sharp decline of the dotcom industry. Similarly, courts have concluded that claims of artificial inflation will not save a complaint if a company's allegedly fraudulent statements or omissions were undisclosed at the time that a stock price dropped as a result of market awareness regarding some independent, intervening cause that can be identified.

Intervening, Price-Reducing, Company Specific Events

The most common situation in which loss causation presents a pleading or proof problem for plaintiffs occurs when, despite a company's material misrepresentations or omissions, the stock price drop is occasioned not by the disclosure of those previously undisputed facts, but by a non-actionable intervening event specific to the company.

The Eleventh Circuit's opinion in *Robbins v. Koger Properties, Inc.*[33] is emblematic of this fact pattern. There, the plaintiff shareholders brought suit after the stock price fell as a result of the company's announcement of its decision to slash its dividend substantially. Plaintiffs alleged this dividend reduction was the result of defendant's failure to comply with Generally Accepted Accounting Principles (GAAP).[34] In short, plaintiffs alleged that, by structuring its finances in

violation of GAAP, defendant had artificially inflated the stock price.

In granting defendant's Rule 50 motion, the court held that although "plaintiffs may have offered sufficient evidence for a reasonable jury to conclude that [the accounting firm's] misrepresentations artificially inflated the price of [the company's] stock during the class period[,] [t]his showing of price inflation . . . does not satisfy the loss causation requirement."[35] Indeed, the court expressly stated that "[o]ur cases do not hold that proof that a plaintiff purchased securities at an artificially inflated price, without more, satisfies the loss causation requirement."[36]

The court noted that the plaintiffs had "offered no evidence of a connection between [the accounting firm's] misrepresentations and the decline in price of [the company's] stock throughout the class period or following the . . . dividend cut."[37] To the contrary, evidence was admitted that defendant "cut its dividend in October 1990 because it was concerned that future financing would not be available to sustain its sales of properties—not because it discovered that past accounting errors had overstated its cash flow."[38] Moreover, "[i]t was not until [after the class period] that [the company] corrected its past operating revenue figures and . . . charged an adjustment for the previous overcapitalizations."[39]

Now, it could be objected that, whatever value *Robbins* may have as precedent at the summary judgment stage, it does not help a defendant on a motion to dismiss. But that misconstrues the significance of the opinion (and others like it that happen to arise in any number of post-Rule 12(b)(6) procedural contexts). Its core legal principle is equally applicable to pleadings, which, even accepted as true, allege no more than price inflation. That is why *Robbins* is frequently cited in the context of judicial dispositions of motions to dismiss.[40]

Moreover, as mentioned earlier, loss causation can be effectively deployed after discovery at the summary judgment stage, by showing that intervening causes unrelated to the alleged misconduct caused the losses.[41] Indeed, sometimes a sharply focused one issue summary judgment motion, made relatively early in the case, can cut through a lot of underbrush and save significant costs.

The Ninth Circuit is least hospitable to defense arguments alleging that price inflation is insufficient. In *Broudo* v. *Dura Pharmacutical, Inc.*,[42] the court held that "loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause."[43] In that case, plaintiffs alleged that defendant and its employees had made materially misleading statements about, *inter alia*, an asthma medication for which the company was seeking FDA approval.[44] The stock price, however, fell almost one year *before* defendants revealed that the FDA had not approved the medicine.[45]

In reinstating plaintiffs' claims, the Ninth Circuit reasoned that

> "[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." Accordingly, for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the transaction. It is at that time that damages are to be measured.[46]

The decision is plainly wrong and wholly inconsistent with the PSLRA causation provision, which the court did not even mention. It should not have been irrelevant to the court that the plaintiffs' complaint did "'not contain any allegations that the FDA's non-approval . . . had any relationship to the . . . price drop [and did] not explain how the alleged misrepresentations and omissions regarding [the medicine] "touched" upon the reasons for the decline in [the company's] stock price.'"[47] Indeed, given that "'the decline in [the company's] stock price was the result of an expected revenue shortfall,'"[48] the result ought to have been outright dismissal of the complaint.

The Ninth Circuit is least hospitable to defense arguments alleging that price inflation is insufficient.

The Supreme Court's decision in *Basic, Inc. v. Levinson*,[49] which held that there is a presumption of transaction causation in cases in which a plaintiff's securities fraud claim was predicated on a "fraud-on-

the-market" theory of liability,[50] is also inconsistent with the Ninth Circuit's decision. The *Broudo* Court's failure to address *Basic* reveals that there is a serious flaw in the court's reasoning: If transaction causation is presumed in cases of fraud-on-the-market and an allegation of artificial price inflation suffices to plead loss causation, the distinction between transaction causation and loss causation disappears altogether. Thus, dissatisfied investors in a bankrupt company could allege that any transaction, even one that occurred and was unwound years before the bankruptcy, permitted the company to continue to operate and therefore ultimately "caused" the plaintiffs' losses. Plaintiffs' test would thus permit virtually any plaintiff to survive the pleading requirements for loss causation, regardless of *which* conduct by *which* actor was actually responsible for the investors' losses, *when* the alleged conduct occurred or was disclosed, or even if intervening causes occurred in the interim.

Supervening, Catastrophic, Industry-Wide Market Forces

A second common fact pattern has been occurring with more frequency as of late and has generated case law quite favorable to defendants. It arises when a corporation discloses information that reveals a material misrepresentation or omission, but an event that has catastrophic effects within an entire industry supervenes, thereby actually causing the shareholders' loss.

At least as long ago as 1990, courts have been willing to dismiss complaints involving such a situation. In *Bastian, III v. Petren Resources Corp.*,[51] the plaintiffs, who had "invested $600,000 in oil and gas limited partnerships promoted by the defendants,"[52] contended that "had it not been for the offering memorandum's misrepresentations and misleading omissions concerning the defendants' competence and integrity, the plaintiffs would not have invested in these partnerships, which [within 3 years] were worthless."[53] The plaintiffs specifically argued that "they should not be required to allege that, but for the circumstances that the fraud concealed, the investment that they were induced by the fraud to make would not have lost its value."[54] They simply argued that "it should be enough to allege that they would not have invested but for the fraud."[55]

The Seventh Circuit rejected this argument because plaintiffs "suggest[ed] no reason why the investment was wiped out."[56] The Court noted that "1981 was a peak year for oil prices and that those prices declined steadily in the succeeding years. When this happened the profitability of drilling for oil (and gas, which generally is produced with it) in the continental United States plummeted."[57] The Court then suggested that if, as a result of this "unexpected drop in oil prices after 1981, all or the vast majority of the oil and gas limited partnerships formed in 1981 became worthless . . . it would be highly unlikely that the plaintiffs' loss was due to the defendants' fraud."[58]

The Court concluded that if a plaintiff "would have lost [his] investment regardless of the fraud, any award of damages to [him] would be a windfall."[59] The Court reasoned that "[n]o social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation."[60] The court noted that while "[d]efrauders are a bad lot and should be punished, . . . Rule 10b-5 does not make them insurers against national economic calamities." *Bastian* is regularly cited with approval both within and without the Seventh Circuit, including many cases adjudicated at the pleading stage.[61]

> ***"The federal securities laws [should not] underwrite, subsidize, and encourage . . . rash speculation."***

Bastian's concern to avoid forcing defendants to assume the role of insurers against all market risk was recently echoed by Judge Pollack in the Southern District of New York case, *In re Merrill Lynch & Co. Research Reports Securities Litigation.*[62] That case involved allegations of fraud-on-the-market resulting from optimistic ratings in eight research reports, which caused the company's stock price to be artificially inflated. The plaintiffs, however, (a) failed to address the fact that the company itself issued positive news on the same days that the research reports were published and (b) failed to differentiate between the challenged

ratings and the rest of the factual information in the research reports that was not challenged. The court dismissed the complaint, finding that the plaintiffs failed to allege that "each of the challenged ratings was the substantial cause of the artificial inflation [of the stock price]."[63] The court reasoned that plaintiffs were simply "high-risk speculators who, knowing full well or being properly chargeable with appreciation of the unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance."[64] It thus concluded that "the federal securities laws [should not] underwrite, subsidize, and encourage . . . rash speculation."[65]

In contrast, in *DeMarco v. Robertson Stephens, Inc.*,[66] Judge Lynch rejected the very argument the *Merill Lynch* court enthusiastically accepted. In denying defendants' motion to dismiss, the court held that the "bursting of the telecommunications stock bubble" could not be found, as a matter of law, to be an intervening cause of plaintiffs' loss because "plaintiffs' theory of the case is that these defendants deliberately participated in inflating the bubble in the first place by disseminating the very misrepresentations at issue."[67] As Judge Lynch put it, "the publication of the intentionally false opinions that allegedly distorted the market price of [the company's] stock contained the seeds of loss causation. Unless an intervening event were to occur first, the author of the false opinion will be appropriately held responsible when the market eventually corrects the artificially inflated price by bursting the bubble."[68]

The court, however, did specifically note that "it is unlikely that loss causation could be adequately alleged in *every* fraud-on-the-market case that successfully pleads transaction causation because in cases in which an unforeseeable intervening event causes the plaintiffs' loss, there is no causal nexus between the loss and the misrepresentation."[69] Moreover, unlike the Merrill Lynch analysts, who were not alleged to have owned the stock about which they issued advice, the defendants in *DeMarco* were alleged to have participated in a "pump and dump scheme." Although defendants were not company insiders and did not "control[] the market sufficiently to manipulate the price at will," nor did the "rapid sell-off of defendants' shares cause[] the price drop," they were alleged to have "misused their status as market commentators to prop up the [company's] stock price until they could unload their own shares."

Simultaneous Disclosure of Actionable and Nonactionable Information

A third scenario in which loss causation arguments may be available to defendants at the motion to dismiss stage arises when the issuer makes a public disclosure that contains more than one piece of new negative information, only some of which is actionable. Most typically, this arises in the context of earnings announcements. A company discloses that its results for the year are below expectations, and simultaneously gives the market guidance about the coming year or quarter, forecasting tough times ahead. The stock price tanks on the news. Obviously, some portion of the price drop—most observers of financial market behavior would say the large part—is attributable to the new forward-looking information, but some is also attributable to the earnings surprise.

Frequently, a plaintiff's ensuing claim is based solely on the theory that the company breached a duty to disclose what it knew about the quarter in progress or that it had previously made bad faith projections. Often, plaintiff does not allege that the new forward-looking disclosures also give rise to a claim. Can the defendant argue that, at the pleading stage, the plaintiff must allege facts that serve to separate out which portion of the loss was caused by the actionable statements? The issue has not been litigated as frequently as it should be. A loss causation defense will not always be successful, especially at the pleading stage. However, if it is clear from the allegations of the complaint that the intervening or supervening event involves factual circumstances that are not alleged to have been concealed or misstated, there is every reason to believe that the decisions discussed in the prior sections would apply with equal force to a case of simultaneous disclosure.

In *Moskowitz* v. *Vitalink Communications Corp.*,[70] shareholders alleged that the defendant had made material misrepresentations that its "financial performance and business prospects" were much better than it knew them to be. After "a DOW Jones wire story quoted [the new President, Chairman, and CEO of the defendant company] as advising that 'there is a rea-

sonable probability' that [the company's] earnings for the third quarter . . . would be" lower than anticipated, the stock price "dropped 25.2%."[71] In seeking a dismissal of the complaint, defendant argued that plaintiffs had not properly alleged loss causation. Specifically, it contended that the stock value dropped in response to the announcement, released the same day as the Dow Jones piece, that the previous President, Chairman, and CEO of the company was resigning. Thus, they argued that his "resignation . . . was an independent intervening event breaking the causal chain between defendant's alleged omissions and the loss suffered by plaintiff as a result of [the company's] stock's precipitous decline."[72]

In rejecting defendant's argument, the court noted that in order to successfully allege loss causation, "a plaintiff must plead that his loss is the result of the defendant's wrongdoing." It noted that in the Ninth Circuit, "loss causation . . . is just another term for proximate cause." In light of the plaintiffs specific allegation that the former CEO "stated to one financial analyst that in fact he had been fired by the Board of Directors because of [the company's] financial difficulties,"[73] the Court held plaintiffs did sufficiently plead loss causation because the "resignation was a *dependent*, rather than *independent*, cause of the stock's plunge."[74] The court distinguished the case from those cited by defendant, noting that those cases "involved *truly independent* causes of the plaintiffs' losses, such as market fluctuations or a change in SEC regulations."[75]

Making the Loss Causation Defense Work at the Pleading Stage

In those circuits in which there has not been a definitive pronouncement by the Court of Appeals that unambiguously lays out the requirements of pleading loss causation, a little more effort is plainly required to persuade a District Court that the Second Circuit line of cases culminating in *Emergent* represents not only the better view of the law, but a view that is consistent with, or perhaps even dictated by the logic of, the precedents of the Circuit you are in.

The Fifth Circuit

The battle lines over the proper delineation of the loss causation requirement have been drawn, and decisions are pending, in several cases in the Fifth Circuit, home to most of the major *Enron* litigations. In the *Enron* case itself, plaintiffs are taking the remarkable position that loss causation is sufficiently pleaded even if all plaintiffs allege is that the defendant was involved in a transaction that was paid off, and thus off Enron's books, years *before* the company's bankruptcy, so long as the transaction played some role in making Enron's financials look better—and by extension in some measure helping buoy its stock price—at a time when some class member was buying. On this theory, of course, it would not matter that the issuer's stock price dropped by virtue of disclosures wholly unrelated to the challenged transaction; all that plaintiff would have to do is allege that the transaction, even one that terminated with a profit years *before* unrelated adverse news was disclosed and the stock price dropped, helped create artificial price inflation.

It is worth pausing to see why Fifth Circuit law should be interpreted to foreclose this result. The precedents in the Fifth Circuit are clear that plaintiffs must plead a "direct causal link between the misstatement and the [plaintiffs'] economic loss" in order to show loss causation.[76]

Plaintiff must "adequately allege a causal connection between defendants' nondisclosures and the subsequent decline in the value of [the relevant] securities."

As the Fifth Circuit held in *Huddleston*, in which a plaintiff purchases a security at a price allegedly inflated by a material misrepresentation, but the plaintiffs' loss is later caused by a different series of events that were not the subject of the alleged misrepresentations, loss causation has not been established.[77] Therefore, there is a compelling argument that, in the Fifth Circuit, an allegation that the plaintiff purchased stock at an inflated price is insufficient as a matter of law to satisfy the loss causation requirement because it fails to separate the distinct concepts of transaction causation (the reason for the transaction) and loss causation (the reason for the plaintiffs' loss).

Defendants in cases pending in the Fifth Circuit have another, closely related argument that the price inflation theory is flatly inconsistent with *Huddleston*. Under plaintiffs' theory, the investors' losses are suffered at the time of the transaction, when the investor purchases a security for an allegedly inflated price. As *Huddleston* makes clear, however, to satisfy the loss causation requirement, the plaintiff must show that the defendants' misconduct caused the plaintiffs' actual, out-of-pocket loss at the time the price of the security declined. Put another way, under the plaintiffs' theory, the hypothetical investor in *Huddleston* would have suffered a loss at the time of the purchase at an allegedly inflated price—not, as the court actually held, when the security later declined in value.

The Eleventh Circuit's decision in *Robbins* should be especially persuasive to the Fifth Circuit in this regard, because Fifth Circuit precedents prior to October 1, 1981, including *Huddleston*, are binding precedent in the Eleventh Circuit,[78] and the Eleventh Circuit accordingly treated *Huddleston* as binding precedent.[79]

Plaintiffs will of course assert that the Second Circuit's recent decision in *Emergent Capital* is inconsistent with Fifth Circuit law, but that argument can be shown to be unconvincing. The Fifth Circuit has not only never rejected the *Emergent* style of analysis, but the Fifth Circuit's approach is *actually* entirely *consistent* with the loss causation standards employed in *Emergent*, which simply employs the tort law concept of proximate cause, *i.e.*, plaintiff must "adequately allege a causal connection between defendants' nondisclosures and the subsequent decline in the value of [the relevant] securities."[80]

Plaintiffs can also be expected to rely heavily on *Broudo v. Dura Pharms., Inc.,*[81] because it, like the Fifth Circuit in *Huddleston* and *Nathensen,* describes the loss causation requirement with language to the effect that the challenged transaction must "touch upon" the reason the security declined in value. But it is a serious mistake to allow plaintiffs to ascribe any talismanic significance to this short-hand phrase. The fact is that, although both the Ninth Circuit in *Broudo* and the Fifth Circuit use the "touch upon" *words*, an analysis of the decisions makes clear they don't mean the same thing at all. As the *Broudo* court acknowledged, other Circuits, including the Eleventh Circuit in *Robbins,* have held that the "touches upon" standard *does* "require demonstration of a corrective disclosure followed by a stock price drop."[82]

The Third, Fourth, Sixth, and Tenth Circuits

Several other circuits, despite relatively sparse case law, certainly yield precedents that give a defense lawyer good ammunition for a loss causation argument.

The Sixth Circuit has only once addressed the issue of loss causation. In *Frylying v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[83] the Court affirmed the District Court's judgment for the defendants and held that "market conditions and not any representations or omissions of [defendants], caused the losses suffered by [plaintiff]."[84] Although the Sixth Circuit has not since discussed the issue of loss causation in a published opinion, it has reaffirmed this decision in at least two unpublished cases.[85] Moreover, every district court case in the Sixth Circuit to cite *Fryling* has found that plaintiffs have failed to either sufficiently alleged or prove loss causation. For example, in *D.E. & J. Ltd. Partnership* v. *Conaway*,[86] the plaintiffs contended that they satisfied the loss causation element simply by alleging that defendant's misrepresentations regarding its financial condition caused plaintiffs to purchase the stock at an artificially inflated price.[87] The Court, however, rejected this argument and dismissed plaintiffs' claim, holding that "a majority of the other Circuits (and the Sixth Circuit in unpublished decisions) have expressly held that this is not sufficient to allege loss causation under Section 10(b) and Rule 10b-5."[88] Moreover, the Court noted that "[p]laintiffs [had not] pleaded facts to show that their losses were caused by defendants' alleged misstatements as opposed to intervening events," such as general stock market decline and the bankruptcy of the company at which defendant executives worked.[89]

Similarly, while the Fourth and Tenth Circuits have not spoken extensively on the subject, decisions in those circuits reach conclusions similar to those of the Sixth Circuit, and thus also lend themselves to an effective defense strategy based on loss causation arguments. [90]

Finally, the leading case in the Third Circuit, *Semerenko v. Cendant Corp.*,[91] held that "[b]ecause a plaintiff in an action under Section 10(b) and Rule 10b-

5 must prove that he or she suffered an actual economic loss, we are persuaded that an investor must also establish that the alleged misrepresentations proximately caused the decline in the security's value to satisfy the element of loss causation."[92] Indeed, *Semerenko* is cited for the proposition that to satisfy loss causation, a plaintiff must demonstrate "(1) that he or she 'purchased a security at market price that was artificially inflated due to a fraudulent misrepresentation,' and (2) 'that the artificial inflation was actually "lost" due to the alleged fraud,' that is, that the stock price 'dropped in response to disclosure of the alleged misrepresentations.'"[93]

Defendants should approach security fraud claims with a critical eye directed towards plaintiffs' allegations of loss causation.

A note of caution, however, regarding *Semerenko* and its progeny is in order. The plaintiffs were shareholders who bought stock in a target corporation based on the acquiring company's market-wide misrepresentations about its own financial stability and strength, which artificially inflated the stock price of the target company.[94] Despite the Court's rule, however, it allowed plaintiffs' claim to proceed because they had properly alleged "that the price of [the target company's] common stock was [not only] 'buoyed' by the defendants alleged misrepresentations, [but also] that it dropped in response to disclosure of the alleged misrepresentations and the termination of the merger agreement."[95]

Conclusion

Despite uncertainty, the overwhelming majority of circuit courts have issued precedents which support a defense argument regarding loss causation. Thus, defendants should approach security fraud claims with a critical eye directed towards plaintiffs' allegations of loss causation. Where those allegations are insufficient to link defendants to plaintiffs' harm, defendants should attack the allegations promptly.

NOTES

1. *See Emergent Capital Inv. Mgmt. LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 196–97 (2d Cir. 2003) ("The causation element has two aspects, both which must be alleged and proven: transaction causation and loss causation."); *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 186 (2d Cir. 2001) (*citing Suez Equity Investors v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001) for the proposition that "[i]t is settled that causation under federal securities laws is two-pronged: a plaintiff must allege both transaction causation, *i.e.*, that but for the fraudulent statement or omission, the plaintiff would not have entered into the transaction; and loss causation, *i.e.*, that the subject of the fraudulent statement or omission was the cause of the actual loss suffered"); *In re Merrill Lynch & Co. Research Reports Secs. Litig.*, 273 F. Supp. 2d 351, 364 (S.D.N.Y. 2003) ("Causation under federal securities laws 'is two pronged: a plaintiff must allege both transaction causation . . . and loss causation . . ..'"); *Greenwald v. Orb Communications & Mktg., Inc.*, 192 F. Supp. 2d 212, 226 (S.D.N.Y. 2002) (same); *D.E. & J. Ltd. P'ship v. Conaway*, 284 F. Supp. 2d 719, 747 (E.D. Mich. 2003) (same); *Morris v. Wachovia Secs., Inc.*, 277 F. Supp. 2d 622, 632 (E.D. Va. 2003) (same); *Nanopierce Technologies v. Southridge Capital Mgmt. LLC*, 2003 WL 21507294 at *5 (S.D.N.Y. June 30, 2003) (same); *Lawrence v. Cohn*, 197 F. Supp. 2d 16, 32 (S.D.N.Y. 2002) *aff'd on other grounds*, 325 F.3d 141 (2nd Cir. 2003) (same); *Robbins v. Koger Properties, Inc.,* 116 F.3d 1441, 1447 (11th Cir. 1997) ("To prove the causation element, a plaintiff must prove both 'transaction causation' and 'loss causation.'"); *Broudo v. Dura Pharm., Inc.*, 339 F.3d 933, 937 (9th Cir. 2003) ("The causation requirement in Rule 10b-5 securities fraud cases includes 'both transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused the harm.'").
2. *Emergent*, 343 F.3d at 196.
3. *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 413 (5th Cir. 2001) (*citing Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) ; *see Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1117 (5th Cir. 1988), *vacated on other grounds sub nom., Fryar v. Abell*, 492 U.S. 914 (1989) ("The causation requirement is satisfied in a Rule10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value.").
4. *Emergent*, 343 F.3d at 197 (quotation omitted); *Coates* v. *Heartland Wireless Communications, Inc.*, 26 F. Supp. 2d 910, 922 (N.D. Tex. 1998) ("To plead loss causation, a plaintiff can allege that he would not have invested had he known the truth, and that the untruth was in some reasonably direct way responsible for the loss.").
5. *See Castillo v. Dean Witter Discover & Co.*, 1998 WL 342050 at *4 (S.D.N.Y. June 25, 1998) (*citing* H.R. Conf. Rep. No. 104-369 at 41 (1995) in support of the proposition that "[t]he purpose of the Private Securities Litigation Reform Act of 1995 . . . was to make more stringent the pleading standard for each of the . . . elements [of a 10b-5 claim] than was generally required previously by Fed.R. Civ.P. 9(b)").
6. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 1995 U.S.C.C.A.N. (109 Stat. 737) 683 ("[T]oday certain lawyers file frivolous strike suits alleging violations of the Federal securities laws in hope that defendants will quickly settle to avoid the expense of litigation.").
7. 15 U.S.C. § 78u-4(b)(4).
8. Although the statutory language speaks in terms of what must be *proven*, the case law has interpreted the language as applying to the pleadings as well. *See Norwood Venture Corp. v. Converse Inc.,* 959 F. Supp. 205, 209 (S.D.N.Y. 1997) ("In an action for federal securities laws violations, a plaintiff must adequately plead loss causation. *See* 15 U.S.C. § 78u-4(b)(4)."); *D.E.J. Ltd. P'ship,* 284 F. Supp. 2d at 746–747 ("The legislative history makes clear that [loss causation] is a pleading requirement: 'The Conference Committee also requires the plaintiff to *plead* and then prove the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff in new Section 21D(b)(4) of the 1934 Act.' H.R. Conf. Rep. No. 104-369 at 41 (1995), reprinted in 1995 U.S.C.C.A.N 730, 740."); *see also Castillo,* 1998 WL 342050, at *4 ("[P]laintiff must plead and prove that the . . . defendants' acts or omissions were proximately responsible for plaintiffs' losses . . ..)"; *In re Merrill Lynch,* 273 F. Supp. 2d at 362 (same); *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495–1496 (2d Cir. 1992) (same).

9. *Emergent*, 343 F.3d 189.
10. *Id.* at 191.
11. *Id.* at 198.
12. *Id.* at 197.
13. *Id.* at 198. Although the court expressly required plaintiff to plead loss causation, the *Emergent* court did ultimately conclude that plaintiff had adequately alleged loss causation albeit not because of defendants' alleged omissions. Rather, plaintiff had properly alleged loss causation by claiming that defendants had personally and directly caused the stock price to decline by dumping their own shares onto the market in a so-called "pump and dump scheme—that is, a scheme where the company principals artificially inflate . . . stock prices before 'dumping' their own shares . . . of stock on the market." *Id.* at 197.
14. *See Citibank,* 968 F.2d at 1495 (dismissing plaintiff's 10b-5 action because plaintiff "suggests no reason why the investment was wiped out. Citibank has alleged the cause of its entering into the transaction in which it lost money but not the cause of the transaction's turning out to be a losing one"); *Bennett v. U.S. Trust Co. of New York*, 770 F.2d 308, 313–314 (2d Cir. 1985) (dismissing plaintiffs' 10b-5 claim when plaintiffs' own unwise decision to invest in public utility stock, and not defendant's misrepresentation that Federal Reserve margin rules did not apply to those stocks, caused their losses); *In re Sterling Foster & Co., Inc. Securities Litigation*, 222 F. Supp. 2d 289, 306-07 (E.D.N.Y. 2002) (dismissing plaintiff's claims of securities fraud because broker-dealer defendants' hypothetical statements as to their ability to manipulate the price of a security did not cause plaintiff's investment losses when there is no allegation that the defendants actually manipulated the price of any security held by the plaintiff); *Greenwald,* 192 F. Supp. 2d at 226–227 (dismissing plaintiff's complaint when he failed to allege any economic loss, much less that the alleged misrepresentations caused his economic loss); *Arduini/Messina P'ship v. National Med. Fin. Servs. Corp.*, 74 F. Supp. 2d 352, 360–362 (S.D.N.Y. 1999) (granting defendants' motion to dismiss where "plaintiffs' . . . injuries occurred prior to the collapse of the market manipulation scheme"); *In re Allied Riser Commns. Corp. (Analysts) Litig.*, 02 CV 7340, Transcript of Hearing at 23–24 (S.D.N.Y. Oct. 20, 2003) (dismissing a securities fraud class action when the complaint failed to allege facts showing that "an ascertainable portion of the actual economic loss the plaintiffs suffered as the price of the stock went down was the result either of the public's learning that the representations previously made by defendants were misrepresentations or . . . could, in some other circumstantial way, be said to have reflected a component attributable to those misrepresentations").
15. S*ee Roots P'ship v. Lands' End, Inc.*, 965 F.2d 1411, 1419 (7th Cir. 1992) (dismissing plaintiffs' complaint for failure to allege that the misrepresentation, which was either corrected prior to the time that plaintiffs purchased the security at issue or occurred after plaintiffs had purchased that security, caused their loss); *D.E. & J. Ltd. P'ship*, 284 F. Supp. 2d at 749–750 & n.26 (dismissing plaintiff's 10b-5 claim when plaintiff alleged only that defendants' misrepresentations about the company's financial condition caused plaintiff to purchase the stock at an artificially inflated price and failed to plead facts showing that defendants' misrepresentations caused plaintiff's investment losses as opposed to intervening events); *Anderson v. First Security Corp.,* 249 F. Supp. 2d 1256, 1268 (D. Utah 2002) (dismissing the complaint for failure to plead any connection between March 15, 2000, public disclosure of defendants' misstatement as to non-recurring income and the stock price decline of March 3, 2000); *Howe* v. *Bank for Int'l Settlements*, 194 F. Supp. 2d 6, 27–28 (D. Mass. 2002) (granting defendants' motion to dismiss "because there is no transaction in which [plaintiff] 'engaged' as a result of [defendants' misrepresentations]"); *In re Cybershop.com Securities Litig.*, 189 F. Supp. 2d 214, 233 (D.N.J. 2002) (granting defendants' 12(b)(6) motion when plaintiff's economic loss was not attributable to misstatements concerning defendants' sales and principal source of third quarter revenue because stock price continued to rise following the company's corrective disclosure and did not fall until after the subsequent publication of a New York Times article criticizing the financial well-being of the company); *Gannon* v. *Continental Ins. Co.*, 920 F. Supp. 566, 580–581 (D.N.J. 1996) (dismissing the complaint when loss did not result from disclosure of misrepresentation regarding the company's reserve for asbestos related and other toxic tort litigation and the subsequent use of those funds to award management bonuses); *In re Polaroid Corp. Secs. Litig.*, 134 F. Supp. 2d 176, 188–189 (D. Mass. 2001) (dismissing plaintiffs' complaint for failure to allege that defendant's GAAP violation with respect to its revenue recognition practices for a $16 million sale of film was a substantial factor in the decline of the stock price); *Morris,* 277 F. Supp. 2d at 632–633 (granting defendant's motion to dismiss because plaintiff failed to allege that defendant's portfolio manager performed deficiently and, in fact, the portfolio mirrored the performance of other national stock indexes during the same time period).
16. *In re Initial Public Offering Secs. Litig*., 2003 WL 23096875 (S.D.N.Y. Dec. 31, 2003).
17. *Id.* at *4.
18. *Id.*
19. *Id.* at *5.
20. Id.; see also In re Worldcom, Inc. Secs. Litig., 2003 WL 22533398, at *9–10 (S.D.N.Y. Nov. 7, 2003) (citing its own prior decision involving WorldCom and holding that the complaint's description of "a synergy between the misrepresentations and omissions in the analyst reports and the public perception of the value of [the] securities . . . and 'the extent which [the defendant's] relationship with [the company] was riddled with conflicts' made it reasonable to infer loss causation . . . that when the alleged illicit relationship came to light 'the disclosure contributed to the decline in price of [the company's] securities'"); BHC Interim Funding, L.P. *v.* Finantra Capital, Inc., 283 F. Supp. 2d 968, 982–983 (S.D.N.Y. 2003) (inferring a causal relationship between the defendant's misrepresentations and omissions which "induced a disparity between the transaction price and the true 'investment quality' of the securities" and plaintiff's decision to invest in defendant's securities); infra (discussing DeMarco v. Robertson Stephens, Inc., 2004 WL 51232 (S.D.N.Y. Jan. 8, 2004)).
21. Manipulation under Section 10(b) is "a term of art [that] cannot be extended to cover every form of unfair dealing which appears to the layperson to be manipulative." *Billard v. Rockwell Int'l Corp.*, 526 F. Supp. 218, 222 (S.D.N.Y. 1981), *aff'd* 683 F.2d 51 (2d Cir. 1982). Instead, "the term generally refers to practices, such as wash sales, matched orders, or rigged prices that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462, 476 (1977); *see also Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 199 (1976) (explaining that the term manipulative "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities").
22. 2003 WL 23096875 at *5.
23. *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 832 (8th Cir. 2003); *see also Franklin High Yield Tax-Free Income Fund v. County of Martin, Minn.*, 152 F.3d 736, 740–741 (8th Cir. 1998) (ruling that plaintiff's allegations concerning defendants' misrepresentations and the resulting inflated purchase price at the time of issuance satisfied the pleading requirements for loss causation in a 10b-5 claim); *Harris v. Union Elec. Co.*, 787 F.2d 355, 366–367 (8th Cir. 1986) (holding that a jury could reasonably find that defendant's misleading representations in its prospectus artificially inflated the value of the bonds and thereby caused plaintiffs' damages); *Stephenson v. Deutsche Bank AG*, 282 F. Supp. 2d 1032, 1058 (D. Minn. 2003) (holding that plaintiffs had sufficiently alleged loss causation as a result of defendants' complex scheme of inflating the price of certain securities); *Lilley v. Charren*, 936 F. Supp. 708, 718 (N.D. Cal. 1996) (finding that "at this preliminary pleading stage," plaintiffs' allegations that defendants' false and misleading statements artificially inflated the price of the security sufficed to plead loss causation); *In re Clearly Canadian Secs. Litig.*, 875 F. Supp. 1410, 1419 (N.D. Cal. 1995) ("Plaintiffs can prove loss causation by demonstrating that the price of Clearly Canadian stock was artificially inflated by defendant's misstatements when plaintiff's purchased their shares.").

24. *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824.
25. *Id.* at 831–832.
26. *Id.* at 832.
27. *Id.* at 831.
28. *Broudo v. Dura Pharm., Inc.*, 339 F.3d 933.
29. *Id.* at 938.
30. *Id.*
31. *See McGonigle v. Combs*, 968 F.2d 810, 819–820 (9th Cir. 1992) (affirming the district court's entry of directed verdict for the defendant when "plaintiffs failed to satisfy the loss causation requirement for Rule 10b-5 cases because they did not show that the existence of the allegedly omitted facts reduced the proper valuation of their investment"); *Burke v. Jacoby*, 981 F.2d 1372, 1379 (2d Cir. 1992) (affirming the grant of summary judgment to defendants when plaintiff "concede[d] that, whatever importance she might have placed on the undisclosed information, she would not have performed the act that was necessary to obtain a better price for her shares"); *Lawrence,* 197 F. Supp. 2d at 32 (granting defendants' motion for summary judgment when fraudulent statements and omissions as to favorable economic circumstances affecting the value of real property at issue in an estate settlement could not cause plaintiff any economic loss because it never had a right of first refusal to purchase all of the partnership interests at issue in the settlement); *Boone v. Carlsbad Bancorporation, Inc.*, 972 F.2d 1545, 1557 (10th Cir. 1992) (holding that minority shareholders cannot prove loss causation between the alleged misleading statements in the proxy statement and the diminution in value of their shares when the "votes of the majority shareholder were sufficient to effect a merger without minority shareholder approval"); *see also infra* n.41.
32. *DeMarco v. Robertson Stephens, Inc.*, 2004 WL 51232 (S.D.N.Y. Jan. 8, 2004) (emphasis added); *see also In re Clearly Canadian,* 875 F. Supp. at 1420 (noting that "plaintiffs will have to come forward with evidence . . . [during] a motion for summary judgment" that defendants' misrepresentations and omissions caused its losses as opposed to some other event); *In re Rent-Way Secs. Litig.*, 209 F. Supp. 2d 493, 513 (W.D. Pa. 2002) (citing that whether or not it was auditor defendant's misrepresentations or the company's misrepresentations that caused plaintiffs loss is an issue of fact not appropriately decided on a motion to dismiss"); *Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.,* 940 F. Supp. 1101, 1126 (W.D. Mich. 1996) (holding that "[w]hether each alleged misrepresentation could have actually been the cause in fact of the [decline in the] price of Perrigo stock is a question properly reserved for summary judgment or a jury verdict").
33. *Robbins v. Koger Props., Inc.*, 116 F.3d 1441.
34. *Id.* at 1444.
35. *Id.* at 1448.
36. *Id.* For the most recent case that adopts this anaylisis *see Drunskin v. Answerthink, Inc*., CCH Fed. Sec L. Rep Para. 92, 663 at 93, 202 (S.D. Fla. Jan. 5, 2004).
37. *Id.*
38. *Id.*
39. *Id.* The Eleventh Circuit recently posed questions concerning the impact of the statutory language in the substantive elements of and pleading requirements for loss causation (and thus on the *Robbins* decision) without suggesting any answers. *La Grasta v. First Union Securities, Inc*. (11th Cir. Jan30, 2004).
40. *Compare D.E. & J. Ltd. P'ship*, 284 F. Supp. 2d at 749–750 and n.26 (dismissing plaintiff's 10b-5 claim when plaintiff alleged only that defendant's misrepresentations about its financial condition caused plaintiff to purchase the stock at an artificially inflated price and failed to plead facts showing that defendant's misrepresentations caused their investment losses as opposed to intervening events); *In re Merrill Lynch & Co. Research Reports Secs. Litig.* 273 F. Supp. 2d 351, 363–364 (S.D.N.Y. 2003) (same) *with In re Rent-Way*, 209 F. Supp. at 513 (noting that (1) "in contrast to *Robbins* . . ., this issue is before us on a motion to dismiss" and (2) quoting a Third Circuit decision for the proposition that "the causation issue becomes most critical at the proof stage. Whether the plaintiff has proven causation is usually reserved for the trier of fact"); *Danis v. USN Communications, Inc.*, 73 F. Supp. 2d 923, 943 n.13 (N.D. Ill. 1999) ("*Robbins* is inapplicable here, as that case dealt with whether the district court should have granted a Rule 50 motion for judgment as a matter of law for insufficient evidence of loss causation.").
41. *See Gasner v. Board of Supervisors of the County of Dinwiddie, Va.*, 103 F.3d 351, 360 (4th Cir. 1996) (granting defendants' summary judgment motion where the inexperience of various personnel, the company's weak financial structure and its inability to secure contracts, as opposed to faulty technology, which had been the subject of the fraudulent disclosure, caused the venture to fail); *In re Imperial Credit Industries, Inc. Secs. Litig.*, 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003) (granting defendants' summary judgment motion as, absent an "event study" linking certain accounting mistakes to the decline in value of defendant company's stock price, plaintiff did not prove that other macro factors such as the Russian default, the Asian crisis or Long Term Capital default did not cause its economic loss); *In re Ikon Office Solutions, Inc. Secs. Litig.*, 131 F. Supp. 2d 680, 687-91 (E.D. Pa. 2001) (granting defendants' summary judgment motion when the evidence suggested that the plaintiffs' loss was attributable to problems unrelated to the alleged misstatements and omissions such as business conditions and operational and management problems); *Unterberg Harris Private Equity Partners, L.P. v. Xerox Corp.*, 995 F. Supp. 437, 442–443 (S.D.N.Y. 1998) (granting summary judgment for defendants when there was no evidence connecting the failure to disclose the gambling problem of a key officer and his ultimate departure as a result of that disclosure and the plaintiffs' loss of its investment due to a decline in stock price and lack of further investor interest).
42. *Broudo v. Dura Pharm., Inc.,* 339 F.3d 933 (9th Cir. 2003).
43 *Id.* at 938; *see also Arthur Young & Co. v. Reeves*, 937 F.2d 1310, 1331–1332 (8th Cir. 1991) (holding that plaintiffs proved loss causation by linking the bankruptcy that caused the plaintiffs' losses to the auditor's nondisclosure of its difficulties in valuing a key asset of the company whose value directly affected the net worth of the company); *In re Ramp Networks, Inc. Secs.*, 201 F. Supp. 2d 1051, 1080–1081 (N.D. Cal. 2002) (denying defendants' motion to dismiss because, despite the fact that the stock decline preceded defendants' disclosure of its fraud, plaintiffs had sufficiently alleged loss causation by asserting that they had purchased the stock at an inflated price).
44. *Broudo*, 339 F.3d at 935.
45. *Id.* at 936.
46. *Id* at 938. (*citing Knapp* v. *Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996)); *Gebhardt*, 335 F.3d at 832; and *Suez Equity Investors, L.P.* 250 F.3d 87, 97–98 (2d Cir. 2001).
47. *Broudo*, 339 F.3d at 937 (*quoting* the district court's opinion, *In re Dura Pharmaceuticals, Inc. Secs. Litig.*, No. 99cv0151-L(NLS), slip op. at 15).
48. *Id.*
49. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).
50. In that case, a plurality of the Supreme Court held that "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Basic*, 485 U.S. at 247.
51. *Bastian, III v. Petren Resources Corp.,* 892 F.2d 680 (7th Cir. 1990).
52. *Id.* at 682.
53. *Id.*
54. *Id.* at 683.
55. *Id.*
56. *Id.* at 684.
57. *Id.*
58. *Id.*
59. *Id.* at 684–685.
60. *Id.* at 685.
61. *Id.; see also Law v. Medco Research, Inc.*, 113 F.3d 781, 786–787 (7th Cir. 1997) (granting defendants' motion to dismiss in which plaintiff failed to contest evidence that the stock price fell in tandem with that of defen-

dants' competitors); *Lillard v. Stockton*, 267 F. Supp. 2d 1081, 1109 (N.D. Okla. 2003) (dismissing plaintiff's complaint for failure to allege that the fraud, and not "a decline in value triggered by the bear market in which several investors sustained a diminution in the value of their investments," caused the loss); *Miller v. New America High Income Fund*, 755 F. Supp. 1099, 1108–1109 (D. Mass. 1991) (granting motion to dismiss because the "cause of [plaintiffs'] loss, as stated repeatedly in the complaint, was the decline of the high-yield bond market" and not defendants' fraud); *D.E. & J. Ltd. P'ship*, 284 F. Supp. 2d at 749–750 & n.26 (dismissing plaintiff's 10b-5 claim in which plaintiff alleged only that defendant's misrepresentations about its financial condition caused plaintiff to purchase the stock at an artificially inflated price and failed to plead facts showing that defendant's misrepresentations caused their investment losses as opposed to intervening events); *Hayden v. Paul, Weiss, Rifkind, Wharton & Garrison*, 955 F. Supp. 248, 257–259 (S.D.N.Y. 1997) (entering judgment for defendant because plaintiff could not prove that its losses were caused by auditor's failure to disclose an illegal transaction in any of the audited financial statements as opposed to an industry-wide downturn that caused comparable losses to other investors).

62. *In re Merrill Lynch & Co. Research Reports Secs. Litig*., 273 F. Supp. 2d at 368.

63. *Id.* at 368 n. 29; *see also In re Merrill Lynch & Co., Inc. Research Reports Secs. Litig.*, 289 F. Supp. 2d 416, 421 (S.D.N.Y. 2003) (reaffirming earlier decision and noting that these plaintiffs have "fail[ed] to plead in any adequate form that it was the rating, as opposed to the unchallenged content of the report or other external factors, that caused the [stock's] decline"); *In re Merrill Lynch & Co., Inc. Research Reports Secs. Litig.*, 272 F. Supp. 2d 243 (S.D.N.Y. 2003) (same).

64. *In re Merrill Lynch*, 273 F. Supp. 2d at 358.

65. *Id.* at 358.

66. *DeMarco v. Robertson Stephens, Inc.*, 2004 WL 51232 (S.D.N.Y. Jan. 8, 2004).

67. *Id.* at *10.

68. *Id.*; *see also Stephenson* v. *Deutsche Bank AG*, 282 F. Supp. 2d 1032, 1058 (D. Minn. 2003) (rejecting defendant's argument that loss was precipitated by the 9/11 terrorist attacks).

69. *Id.* at *11.

70. *Moskowitz v. Vitalink Communications Corp.*, 751 F. Supp. 155 (N.D. Cal. 1990).

71. *Id.* at 157.

72. *Id.* at 159.

73. *Id.* at 157.

74. Id. at 159.

75. *Id.* (emphasis added); *see also In re McKesson HBOC, Inc. Secs. Litig.*, 126 F. Supp. 2d 1248, 1268–1269 (N.D. Cal. 2000) (denying a motion to dismiss and rejecting a similar argument in which defendant auditors contended that the decline in market was the result of a disclosure of prior misconduct, of which they were not a part, as opposed to a warning of possible future disclosures that may involve them).

76. *Nathensen,* 267 F.3d at 413; *see Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) (stating that to satisfy loss causation requirement, plaintiff "must prove that . . . the untruth was *in some reasonably direct, or proximate, way* responsible for his loss") (emphasis added); *see also In re Enron Corp. Secs., Derivative and ERISA Litig.*, 235 F. Supp. 2d 549, 573 n.13 (S.D. Tex. 2002) ("[L]oss causation refers to a *direct causal link* between the misstatement and the claimant's economic loss.") (emphasis added).

77. *Huddleston*, 640 F.2d at 549 n.25.

78. *Bonner* v. *City of Prichard, Alabama*, 661 F.2d 1206, 1207 (11th Cir. 1981).

79. *See, e.g., Robbins*, 116 F.3d at 1448 (citing *Huddleston* and rejecting the argument that a showing of price inflation at the time of plaintiffs' purchase satisfies the loss causation requirement, on the ground that "[o]ur decisions explicitly require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value").

80. *Emergent Capital*, 343 F.3d at 197; *see also id.* ("We have often compared loss causation to the tort law concept of proximate cause . . ."); *cf. Huddleston*, 640 F.2d at 549 (stating that loss causation requires the court to consider whether "the misrepresented fact [was] a proximate cause of the [plaintiffs'] loss").

Moreover, *Coates v. Heartland Wireless Communications, Inc.*, 26 F. Supp. 2d 910 (N.D.Tex.,1998), which denied a defendant's motion to dismiss on loss causation grounds, is nevertheless also consistent with the requirement that plaintiffs show a decline in the price of the stock after truth about the alleged misrepresentation was disclosed. The court in that case, which revealingly, does *not* cite *Huddleston* in support of its analysis, held that the particular complaint satisfied the loss causation requirement because plaintiffs had "at a minimum adequately alleged that the price was artificially inflated on [the day of disclosure] by asserting that the significant decline in price at record volume on the following day *was a result of disclosing the 'truth.'*" *Id.* (emphasis added). For the more recent district court decision in this Circuit, re *In re Electronic Data Sys. Corp. Sec. Litigation*, 2004 WL 52088 (E.D.Tex., Jan. 13, 2004).

81. *Broudo v. Dura Pharms., Inc.*, 339 F.3d 933 (9th Cir. 2003).

82. *Id.* at 939 n. 4 (*citing Semerenko* v. *Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000); *Robbins* v. *Kroger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997)).

83. *Frylying v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 593 F.2d 736 (6th Cir. 1979).

84. *Id.* at 744.

85 *See Rowe* v. *Marietta Corp.*, 1999 WL 16571 (6th Cir. Jan. 6, 1999) and *Campbell* v. *Shearson/ American Exp., Inc.*, 1987 WL 44742 (6th Cir. Sept. 9, 1987).

86. *D.E. & J. Ltd. P'ship v. Conaway*, 284 F. Supp. 2d 719.

87. *Id.* at 749.

88. *Id.*; *see also Rubin* v. *Schottenstein, Zox & Dunn*, 119 F. Supp. 2d 787, 790–791 (S.D. Ohio 2000); *Wieringa* v. *Oppenheimer & Co., Inc.*, 1985 WL 510 at *9 (N.D. Ohio Mar. 7, 1985); *Murray* v. *Hosp. Corp. of Am.*, 682 F. Supp. 343, 346-47 (M.D. Tenn. 1988); *Baumann* v. *L & J Energy, Inc.*, 1991 WL 319385 at *3-4(W.D. Mich. Mar. 31, 1991).

89. *D.E. & J. Ltd. P'ship* at 749 n.26.

90. *See Gasner* v. *Board of Supervisors of the County of Dinwiddie, Va.*, 103 F.3d 351, 360 (4th Cir. 1996) (entering judgment for the defendant on the basis that plaintiffs "have failed to produce evidence . . . to show that the alleged misrepresentations or omission [by defendants] proximately caused their damages"); *Boone* v. *Carlsbad Bancorporation, Inc.*, 972 F.2d 1545, 1557 (10th Cir. 1992) (same); *Ames* v. *Uranus, Inc.*, 1994 WL 482626, at *25 (D. Kan. Aug. 24, 1994) (same); *Morris,* 277 F. Supp. 2d at 632–633 (entering judgment for the defendant as a result of plaintiff's failure to sufficiently plead loss causation).

91. *Semerenko v. Cendant Corp*., 223 F.3d 165.

92. *Id.* at 185.

93. *In re Ikon*, 131 F. Supp. 2d at 687 (*quoting Semerenko*, 223 F.3d at 184–186); *see also In re Initial Public Offering Secs. Litig.*, 2003 WL 23096875, at *2 n.13 (same).

94. *Id.* at 169–172.

95. *Id.* at 186. Moreover, later that same year, in *E.P. Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865 (3rd Cir. 2000), the Court categorized the *Semerenko* case as "adopt[ing] a practical approach, in effect applying general causation principles." *Id.* at 884. The Court then favorably cited an Eighth Circuit decision, which held that "'plaintiffs are not required to meet a strict test of direct causation under Rule 10b-5; they need only show some causal nexus between the defendant's improper conduct and plaintiff's losses.'" *Id.* (*quoting In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619 (8th Cir. 1991)). The court then reiterated

that this case was not the typical artificial inflation case: rather than basing its allegation of securities fraud on a theory of fraud-on-the-market, plaintiff, like that in *Emergent,* alleged fraud "as a result of personal representations directly made to its executives by [defendant's] executives." *Id.* at 871; *see also id.* at 884.

Reprinted from *Insights* February 2004, Volume 18, Number 2, pages 13-24,
with permission from Aspen Publishers, Inc., A WoltersKluwer Company, New York, NY,
1-800-638-8437, www.aspenpublishers.com.

A WoltersKluwer Company