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Pleading Loss Causation In Securities Fraud Cases:
What Investors, Companies, & Their Counsel Need To Know

#4890
Pleading Loss Causation In Securities Fraud Cases: What Investors, Companies, And Their Counsel Need To Know

By Lyle Roberts, Paul Chalmers and Nicholas Porritt

In any action for securities fraud under Rule 10b-5, one of the elements the plaintiff must plead and ultimately prove is loss causation, *i.e.*, that the alleged fraud caused the plaintiff to actually suffer an economic loss. For decades, the courts largely ignored the issue of what facts a plaintiff must allege to successfully plead loss causation. The past year, however, has seen the issue come to the fore largely because so many claims now before the courts involve the issue of whether the plaintiffs’ losses resulted from fraud or from the general market downturn at the beginning of the decade. This is particularly true in cases stemming from allegedly biased research reports.

Beginning with the controversial decision by Judge Milton Pollack of the Southern District of New York in *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003), dismissing several securities fraud complaints based on allegedly biased research reports on loss causation grounds, a host of courts have begun reexamining the meaning of loss causation and, critically, the role it plays at the pleading stage. No fewer than three courts of appeals have issued opinions reaffirming or clarifying their requirements for pleading loss causation, in the process bringing a circuit split into sharp relief. District court judges – particularly within the Southern District of New York – have begun a vigorous debate on the issue. The trend shows no signs of abating, particularly as these decisions wend their way through the appellate process.

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Two primary approaches have emerged: the “purchase price disparity” approach and the “price decline” approach. Under the purchase price disparity approach, the court focuses on the moment the plaintiff purchased his security. If the plaintiff can show that his purchase price was inflated at that time due to the defendants’ misconduct, he has established loss causation. Under the price decline approach, a second step is required. Not only must the plaintiff show that the defendants fraudulently inflated the stock price at the time of his purchase, he must also show that he lost some or all of his overpayment, usually by alleging a corrective price decline after revelation of the fraud.

The debate over the two competing approaches has significant practical consequences. Under the price decline approach, loss causation is a significant pleading burden and, in some cases, will present an opportunity for defendants to successfully dismiss a complaint or prevail on summary judgment. Under the purchase price disparity approach, loss causation is relatively straightforward to plead and involves a largely factual inquiry that is very difficult to resolve short of trial.\(^2\)

This article will attempt to guide the reader through the thicket of pleading loss causation. Section I will explain the concept of loss causation and put it into context by describing its relationship to other securities law concepts and developments. Section II will describe in detail the two approaches to loss causation that have developed and the rationales for each approach. Section III will present a summary of notable decisions issued over the past year.

\(^2\) As discussed in an interesting working paper recently released by NERA Economic Consulting, damages calculated using the purchase price disparity approach could differ greatly from damages calculated under the price decline approach. See Dr. David Tabak, Loss Causation and Damages in Shareholder Class Actions: When It Takes Two Steps To Tango (accessible on the NERA website – www.nera.com).
I. THE DEVELOPMENT OF LOSS CAUSATION

To prevail in a Rule 10b-5 cause of action, a plaintiff must establish that “the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that plaintiff’s reliance on defendant’s action caused injury to the plaintiff.” Lawrence v. Cohn, 325 F.3d 141, 147 (2d Cir. 2003) (emphasis added) (internal quotations and citations omitted). Courts have broken the causation requirement into two separate and distinct elements, both of which must be pled and proven: transaction causation and loss causation. Transaction causation requires proof that the alleged misconduct induced the plaintiff to engage in the transaction in question. It is equivalent to the actual or “but for” causation in tort law and closely related to the separate Rule 10b-5 requirement of reliance. Loss causation, on the other hand, is established by proof that the alleged misconduct caused the plaintiff’s economic loss.

The development of loss causation pleading standards has been driven by a number of legal doctrines and requirements. The first is the fraud-on-the-market doctrine. Under the fraud-on-the-market doctrine (adopted by the Supreme Court in Basic, Inc., v. Levinson, 485 U.S. 224 (1988)) a securities fraud plaintiff need not allege or prove that he relied on – or was even aware of – an alleged misstatement. Rather, “reliance on the statement is rebuttably presumed if the plaintiffs can show that (1) the defendant made public material misrepresentations, (2) the defendant’s shares were traded in an efficient market, and (3) the plaintiffs traded shares between the time the misrepresentations were made and the time the truth was revealed.” Greenberg v. Crossroads Sys. Inc., 364 F.3d 657, 661 (5th Cir. 2004) (citation omitted). Put somewhat differently, the fraud-on-the-market doctrine allows the plaintiff to rely on the market price of the security, which incorporates and reflects the statement at issue.
Although the fraud-on-the-market doctrine applies directly to the issue of reliance, it has two consequences for loss causation. First, courts have held that transaction causation is also satisfied through the fraud-on-the-market doctrine (i.e., the market price incorporates the statements and investors both rely on the integrity of that price and are induced to purchase the security based on that price). Second, the fraud-on-the-market doctrine assumes the existence of an efficient market that incorporates all public information into the security price. As a result, the factual context in fraud-on-the-market cases is broader than in conventional fraud cases and allows courts to examine market indications of loss (i.e., market price declines and public information about the causes of those declines) in determining whether the plaintiff was damaged by the alleged fraud.

The second driving factor is the Private Securities Litigation Reform Act (“PSLRA”). The PSLRA had two important impacts on loss causation. First, it codified the loss causation requirement. See 15 U.S.C. § 78u-4 (b)(4) (“in any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.”) What had been a judicially created element of a Rule 10b-5 action is now statutory. Second, although the PSLRA did not specify the pleading standards for loss causation, it did tighten the pleading standards for Rule 10b-5 claims generally. As a result, it altered the mindset of defendants and judges with respect to motions to dismiss. Defendants became more aggressive in bringing them, and judges more willing to closely examine the adequacy of complaints – including as to loss causation.

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3 Congress enacted the PSLRA in 1995 to deter abusive lawsuits and encourage the voluntary disclosure of information by corporate issuers. To that end, the legislation established heightened pleading requirements for securities fraud, an automatic stay of discovery in securities fraud cases pending the resolution of a motion to dismiss, a system for selecting a lead plaintiff in a case brought as a class action, and a safe harbor from liability for forward-looking statements.
The final development that has brought loss causation to prominence is the extraordinary rise and crash in the stock market at the turn of the century, especially in technology stocks, and the regulatory response. Massive stockholder losses coupled with the subsequent disclosure of unsavory, and allegedly fraudulent, practices by Wall Street investment banks has led to a flurry of lawsuits alleging a link between the two. Courts have had to grapple with an essential question: did the investment banks cause the identified losses or were they the result of market forces? The result has been a number of notable loss causation decisions and a great deal of focus on the issue.

II. THE CIRCUIT SPLIT

Two camps have emerged in the circuit courts as to what a plaintiff must allege to adequately plead loss causation. The distinction between the two approaches rests largely on the court’s view of the appropriate definition of “loss.”

A. The Minority Approach: Purchase Price Disparity

The Eighth and Ninth Circuits have adopted the purchase price disparity approach to pleading loss causation. These circuits do not require a plaintiff to allege a decline in the value of their securities following purchase. Rather, a plaintiff need only allege that the misleading statement inflated the price of the security in question at the time the plaintiff purchased it. As the Ninth Circuit explained last year,

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 the damages are to be measured. Thus, loss causation does not

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4 Eighth Circuit: Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824 (8th Cir. 2003); In re Control Data Corp. Sec. Litig., 933 F.2d 616 (8th Cir. 1991).

Ninth Circuit: Broudo v. Dura Pharms., Inc., 339 F.3d at 933 (9th Cir. 2003); Knapp v. Ernst & Whitney, 90 F.3d 1431 (9th Cir. 1996).
require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of the purchase was overstated and sufficient identification of the cause.

_Broudo_, 339 F.3d at 938 (citations omitted). In short, if the plaintiff alleges a “purchase price disparity,” the loss causation requirement is satisfied. _Id._

To adequately allege that the price was inflated as of the date of purchase, the plaintiff only need allege that the misrepresentation was material; if the misrepresentation was material, the court will presume that it inflated the price of the security. In other words, the plaintiff may simply rely on the fraud-on-the-market doctrine to show loss causation. _Gebhardt_, 335 F.3d at 831 (“Our finding of materiality allows the plaintiffs to invoke the fraud-on-the-market theory and assume that the misrepresentations inflated the stock’s price.”); _Knapp_, 90 F.3d at 1438 (“In a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.”) (citation omitted). As a result, in jurisdictions following the minority approach, the plaintiff should be able to plead loss causation without much difficulty, and courts normally will deny motions to dismiss based on that issue.

**B. The Majority Approach: Price Decline**

In contrast, the Second, Third, Seventh, and Eleventh Circuits have rejected the idea that plaintiffs may rely on the fraud-on-the-market doctrine to plead loss causation. As one district court has stated “allowing plaintiffs in a fraud on the market case to satisfy loss causation simply by alleging that a misrepresentation caused the price to be artificially inflated without having to allege any link between the conduct and the decline in price would undoubtedly lead to speculative claims and procedural intractability.” _Merrill Lynch_, 273 F. Supp. 2d at 366 n. 28. Instead, these courts require the plaintiff to show that the price of the security declined after the plaintiff’s purchase, and
that the alleged fraud was a substantial factor in causing this decline. 5 To satisfy this requirement, the plaintiff typically will be required to show that there was a corrective disclosure followed by a drop in the price of the security. 6

The rationale for the majority approach is that a purchase price disparity, by itself, is not a compensable injury. Unless the price of the security declines as a result of exposure of the alleged fraud, the plaintiff has not been damaged. As the Third Circuit explained in Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000),

Where 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.


Based on unreported decisions, it appears that the Sixth Circuit may also have joined the majority approach camp. See, e.g., Campbell v. Shearson/American Exp., Inc., Nos. 85-1703, 85-1714, 1987 WL 44742 1 at *2 (6th Cir. Sept. 9, 1987) (“If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule [10b-5] is not permitted.”)

6 In rare instances, an actual price decline may not be necessary. For example, a company could release unrelated positive information along with the corrective disclosure so that the stock price does not decline. Nonetheless, there may still be a loss sufficient to bring a claim because the “stock does not appreciate as it would have absent the fraudulent conduct.” Gebhardt, 335 F.3d at 831-32.
(citation omitted). Thus, under the majority approach, loss causation is a necessary corollary to the fraud-on-the-market doctrine. While the latter allows the plaintiff to assume that optimistic statements have driven a security price higher, the former requires that plaintiff to show how the falsity of those statements caused the security price to decline.

The effect of the price decline approach to pleading loss causation depends heavily on the fact pattern presented to the court. On the one hand, many securities fraud claims follow a simple course of events that allows for a direct link between the alleged fraud and a stock price decline. For example, a securities fraud claim based on a financial restatement that lowers previously announced earnings and results in a stock price decline would appear to present few loss causation pleading issues. On the other hand, the courts are seeing a raft of securities fraud cases presenting more difficult scenarios, including cases involving significant intervening causes (e.g., the stock market crash) or where the corrective disclosure does not move the market or cannot be linked to the substance of the alleged misrepresentations. In these circumstances, courts are proving willing to exercise close scrutiny of the complaint, and, in some cases, grant dismissals.

C. Next Step: The Supreme Court

It is possible that the circuit split over loss causation may soon be resolved. The defendants in the Broudo litigation have requested interlocutory review of the Ninth Circuit’s ruling by the Supreme Court. That request has been fully briefed and is now awaiting a decision. Importantly, the Solicitor General and the SEC have submitted an amicus brief siding with the request for review. In that amicus, they argue that the Ninth Circuit’s application of the purchase price disparity approach was wrong, i.e., that the price decline approach is the appropriate standard rule for alleging loss causation. Given the weight the Supreme Court typically accords the Solicitor General’s positions, this submission could make Supreme Court review in Broudo more likely.
III. RECENT DEVELOPMENTS

The past year witnessed an unprecedented number of decisions addressing loss causation. Three circuits plus numerous district court judges issued rulings defining or applying standards for loss causation allegations. A summary of these cases follows:

A. 2nd Circuit

_Emergent Capital Inv. Mgmt. v. Stonepath Group, Inc._: Adopting price decline.

The Second Circuit issued an opinion in _Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc._, 343 F.3d 189 (2d Cir. 2003), squarely aligning that circuit with the price decline approach. In that case, the plaintiff, an investment fund manager, alleged a “pump and dump” scheme whereby the defendants solicited the plaintiff into purchasing shares through a private placement. Although the Second Circuit found that the “pump-and-dump” allegations were enough to plead loss causation, Judge Cardamone, who wrote the court’s opinion, took exception to the plaintiff’s attempt to cite his earlier decision in _Suez Equity Investors, L.P. v. Toronto-Dominion Bank_, 250 F.3d 87 (2d Cir. 2001), for the position that the Second Circuit had adopted a purchase price disparity approach.

Devoting an entire section of the opinion to the question, Judge Cardamone stated:

> We did not mean to suggest in _Suez Equity_ that a purchase-time loss allegation _alone_ could satisfy the loss causation pleading requirement. To the contrary, we emphasized that the plaintiffs had “also adequately alleged a second, related, loss--that [the executive’s] concealed lack of managerial ability induced [the company’s] failure.” Moreover, we expressly distinguished that case from one where the ultimate decline in the market price of a company’s securities would be unrelated to that company’s manager’s concealed negative history.

_Emergent_, 343 F.3d at 198-99. Accordingly, the Second Circuit concluded that plaintiffs must continue to conform to the Circuit’s “established requirement that securities fraud plaintiffs
demonstrate a causal connection between the content of the alleged misstatements or omissions and ‘the harm actually suffered.’” Id. at 199. The court further noted, however, “if the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation will not have been established. But such is a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss.” Id. at 197.

**Merrill Lynch:** Motions to dismiss granted.

Although *Emergent Capital* provided the general standards, the real action within the Second Circuit was in the Southern District of New York. Even after the Second Circuit handed down its decision in *Emergent Capital*, the Southern District of New York issued a stream of conflicting rulings regarding loss causation. Most of these decisions were issued in the research analyst cases, and the facts are largely the same. The plaintiffs allege that securities analysts at brokerage firms issued overly optimistic research reports regarding the stocks of certain companies – mostly in the tech industry – in return for underwriting business. The plaintiffs are not customers of the research analysts, but simply purchased shares on the open market of stocks covered by the research reports.

From a loss causation standpoint, the problem these plaintiffs confront is that the stock price decline occurred before any corrective disclosures regarding the alleged conflicts of interest. Specifically, the prices of the stocks in question declined when the tech bubble collapsed in 2000. The research analysts’ alleged fraudulent conduct was not revealed until years later, when the New York Attorney General’s office began publicizing the issue. In order to show loss causation, therefore, the plaintiffs initially relied largely on the purchase price disparity approach, *i.e.*, that the research reports inflated the stock prices at the time plaintiffs purchased.

In June 2003, however, Judge Pollack dealt this argument a severe blow by dismissing two class actions pending against Merrill Lynch on the grounds that the plaintiffs had failed to
adequately plead loss causation. *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003). Applying a strong version of the price decline approach, Judge Pollack found that merely alleging that the stock price was artificially inflated is not sufficient to satisfy loss causation, stating that to allow this “would undoubtedly lead to speculative claims and procedural intractability.” *Id.* at 366 n.28. Instead, the plaintiffs needed “to allege facts which, if accepted as true, would establish that the decline in the prices of 24/7 and Interliant stock (their claimed losses) was caused by any or all of the alleged omissions from the analyst reports.” *Id.* at 363. Finding that there was no alleged connection between the analyst reports and the companies’ financial troubles or the collapse of the overall market, the court held that the plaintiffs failed to meet their pleading burden. *Id.*

In October 2003 – weeks after the Second Circuit endorsed the price decline approach in *Emergent Capital* – Judge Pollack dismissed an additional eight class actions against Merrill Lynch. *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 289 F. Supp. 2d 416 (S.D.N.Y. 2003). Again, he found that the plaintiffs failed to adequately link their losses to revelations of the alleged scheme, concluding that the only explanation for the losses was the tech bubble collapse, an intervening cause. *Id.* at 420-21. Judge Pollack also took pains to explain that the Second Circuit’s pronouncement in *Emergent* that intervening causation “is a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss” (*Emergent*, 343 F.3d at 197) was *dicta* and did not foreclose dismissal based on an intervening cause, when such a cause is evident from the face of the complaint and facts susceptible to judicial notice.7 *Merrill Lynch*, 289 F. Supp. 2d at 422.

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7 Judge Pollack used essentially the same reasoning to dismiss still another research analyst claim against Merrill Lynch in February 2004. *See In re Merrill Lynch Tyco Research Sec. Litig.*, No. 03 CV 4080(MP), 2004 WL 305809 (S.D.N.Y. Feb. 18, 2004).
However, not all of the judges in the Southern District of New York have been willing to apply the loss causation pleading requirements as strictly as Judge Pollack. Thus, in a number of cases where the facts have diverged from those in the *Merrill Lynch* cases, either because of allegations that the research analyst directly participated in a fraudulent scheme perpetrated by the issuer defendant or the revelation of the analyst’s conduct caused a subsequent stock price drop, courts have refused to dismiss the complaint based on loss causation.

**WorldCom:** Motions to dismiss denied.

In May 2003, Judge Cote denied the defendants’ motions to dismiss in *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392 (S.D.N.Y. 2003). The complaint alleged that WorldCom “engaged in a series of illegitimate accounting strategies in order to hide losses and inflate reported earnings.” *Id.* at 397. It also alleged that investors were misled by Jack Grubman, an influential Salomon Smith Barney (“SSB”) telecommunications analyst, who knew of WorldCom’s accounting irregularities. *Id.* at 404. His analyst reports were alleged to be “false and misleading not only because they misrepresented WorldCom’s financial condition, but also because they failed to disclose key information regarding the nature and extent of an illicit *quid pro quo* arrangement that existed between the SSB Defendants and WorldCom.” *Id.*

In ruling that the plaintiffs had adequately alleged loss causation, Judge Cote focused on the allegations that Grubman had misstated WorldCom’s financials in his reports, despite his possession of accurate material, non-public information. *Id.* at 428.⁸ Because his alleged misstatements were so closely related to those of the WorldCom defendants – both in terms of timing and subject matter

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⁸ Judge Pollack relied on this fact in distinguishing *Merrell Lynch* from *WorldCom*. Judge Pollack noted that there were no allegations in *Merrill Lynch* that the analyst possessed material, non-public information that contradicted his research reports. 273 F. Supp. 2d at 364 n.25.
– the court essentially treated him as another officer of the company for loss causation purposes. *Id.*

In other words, the plaintiffs satisfied loss causation as to Grubman by linking the company’s restatement to statements in Grubman’s research reports.

Judge Cote only addressed the alleged *quid pro quo* arrangement in a subsequent opinion five months later – after the Second Circuit issued *Emergent Market* – when the court denied the defendants’ request for interlocutory appeal. *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), 2003 WL 22533398 (S.D.N.Y. Nov. 7, 2003). Importantly, the defendants had only challenged Judge Cote’s refusal to dismiss the claims based on the alleged conflict of interest; they did not challenge the court’s ruling that the plaintiffs had adequately alleged loss causation as to specific misrepresentations in Grubman’s reports. Judge Cote ruled that the alleged *quid pro quo* arrangement was simply intertwined too closely with Grubman’s alleged misstatements for the court to parse them out, especially on a motion to dismiss, and since the complaint would have survived regardless of the court’s ruling on the conflict of interest allegations, there was no reason for the court to do so. *Id.* at *10-12.

**DeMarco v. Lehman Bros., Inc.:** Motion to dismiss denied.

In March 2004, Judge Rakoff denied a motion to dismiss a research analysts claim against Lehman Brothers. *DeMarco v. Lehman Bros., Inc.*, 309 F. Supp. 2d 631 (S.D.N.Y. 2004). The plaintiffs in that case alleged that a Lehman analyst made buy recommendations for RealNetworks, Inc. stock during the class period while secretly holding negative views of the stock. In October 2000, the stock price declined, allegedly causing the plaintiffs’ losses, when the information on which the analyst based his negative views was revealed to the market. The investors did not discover that the Lehman analyst had misled them about his opinion on RealNetworks until the release of certain e-mails by the SEC in April 2003. On the issue of loss causation the court held:
[A]ssuming arguendo that plaintiffs must plead that their losses proximately resulted from the marketplace’s reaction to the revelation of the truth that defendant’s actionable statements concealed (as contrasted to independent market forces), the Complaint adequately alleges that in or around October, 2000 the market was finally apprised of the negative information concerning RealNetworks that had earlier led [the Lehman analyst] to take a secretly negative view of the stock and that, as a result of these revelations, the stock declined, causing the losses on which plaintiff here suits.

Id. at 636. Accordingly, the court concluded that the plaintiffs had satisfied their pleading burden.

There is no discussion in the Lehman Brothers opinion of any facts demonstrating that the analyst knew about negative information concerning RealNetworks that was not available to the market. Nevertheless, the language in the court’s opinion clearly suggests that the court adopted the same approach as Judge Cote in WorldCom. That is, because there was sufficient evidence that the analyst participated in deceiving investors as to RealNetworks’ true state of affairs, the relevant event for loss causation purposes was the disclosure of the truth regarding RealNetworks. Id.

DeMarco v. Robertson Stephens, Inc.: Motion to dismiss denied.

In January 2004, Judge Lynch denied a motion to dismiss in an analyst action against Robertson Stephens, relying on the fact that there had been a decline in the stock price following revelation of the analysts’ alleged conflict of interest. DeMarco v. Robertson Stephens, Inc., No. 03 Civ. 590 (GEL), 2004 WL 51232 (S.D.N.Y. Jan. 9, 2004). The complaint alleged that Robertson Stephens’ analysts made buy recommendations for Corvis stock to prop up the price until the firm and some of its executives could sell off their pre-IPO shares (i.e., a variation on a “pump-and-dump” stock manipulation). A May 2001 article in the New York Times revealed the alleged scheme when it reported the discrepancy between Robertson Stephens’ public recommendations and the sales by its executives. In the opinion, Judge Lynch noted that the price of Corvis stock dropped 16% within a few days of the article.
Just as in *Merrill Lynch*, the defendants argued that the plaintiffs’ loss was due to the general market downturn, not alleged misrepresentations. The court agreed that the plaintiffs could not merely allege that the price of Corvis shares had been inflated, holding 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 where an unforeseeable intervening event causes the plaintiffs’ loss, there is no causal nexus between the loss and the misrepresentation.” *Id.* at *11. In the instant case, however, the court found that “the bursting of the Corvis stock bubble could reasonable be construed, at least in part, as the market’s correction of an inflated stock price, pumped up in part by defendants’ false statements about its opinions.” *Id.* The court also took pains to distinguish the case from *Merrill Lynch*, noting that “in this case there is evidence that disclosure of defendants’ scheme caused a further decline in the price of Corvis stock, even after the overall bubble had burst.” *Id.* at *13 n.7.

**AOL Time Warner:** Motion to dismiss denied.

At least one judge has refused to even consider the issue of loss causation on a motion to dismiss based on a very literal reading of *Emergent Capital’s* pronouncement on intervening causes. In *In re AOL Time Warner, Inc. Sec. and “ERISA” Litig.*, No. 1500, 02 Civ. 5575 (SWK), 2004 WL 992991 (S.D.N.Y. May 5, 2004), Judge Kram denied a motion to dismiss in a case based on a financial restatement. The defendants had moved to dismiss the complaint based, in part, on loss causation, arguing that the plaintiffs had not adequately alleged that their losses stemmed from the

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9 Interestingly, on February 17, 2004, Judge Lynch dismissed two other research analyst cases against Roberston Stephens which were based on similar allegations. *Podany v. Robertson Stephens, Inc.*, No. 03 Civ. 3961 (GEL) 2004 WL 307296 (S.D.N.Y. Feb. 17, 2004). In *Podany*, Judge Lynch found that the plaintiff had failed to adequately allege facts showing scienter, *i.e.*, that the analyst really did not believe the opinions he expressed.
restatement as opposed to the general downturn in technology stocks. In rejecting that argument, the court appeared to rely on the purchase price disparity approach. Citing *Suez Equity*, Judge Kram held that a plaintiff satisfies the loss causation requirement “by demonstrating that ‘defendant’s misrepresentations induced a disparity between the transaction price and the true ‘investment quality’ of the securities at the time of the transaction.’” *Id.* at *27* (quoting *Suez Equity*, 250 F.3d 87). The court then stated, without detailed discussion, that the plaintiffs had satisfied that standard.

In a footnote, Judge Kram agreed with the defendants that *Emergent Capital* governs loss causation generally in the Second Circuit. In contrast with Judge Pollack’s reading of the case, however, the court concluded that the Second Circuit had meant that intervening causation was *never* to be decided on a motion to dismiss, but left for resolution at trial. *Id.* at *27* n.39. Accordingly, the court refused to consider the defendants’ arguments regarding intervening causation. Based on the decision, the court appeared to believe that the price decline approach is only to be applied at trial, while the purchase price disparity approach should be applied at the motion to dismiss phase.

**IPO Securities Litigation:** Motion to dismiss denied.

Another court distinguished Judge Pollack’s decisions and *Emergent Capital* by classifying the claims before it as claims of market manipulation rather than misstatements. *In re Initial Public Offering Sec. Litig.*, 297 F. Supp. 2d 668 (S.D.N.Y. 2003). In that case, the underwriter defendants “allegedly required or induced their customers to buy shares of stock in the aftermarket as a condition of receiving initial public offering stock allocations.” *Id.* at 669. This conduct caused the plaintiffs to purchase the stock at an artificially inflated price. Additionally, the underwriter defendants “allegedly received inflated commissions or other undisclosed compensation in exchange
for IPO allocations.” *Id.* The plaintiffs brought Rule 10b-5 claims for (1) market manipulation and (2) material misstatements and omissions.

Although the court acknowledged that claims based on misstatements and/or omissions require a showing of price decline, it reasoned that claims based on market manipulation are different:

A market manipulation is a discrete act that influences stock price. Once the manipulation ceases, however, the information available to the market is the same as before, and the stock price gradually returns to its true value. . . . In market manipulation cases, therefore, it may be permissible to infer that the artificial inflation will inevitably dissipate. That being so, 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 caused plaintiffs’ loss.

*Id.* at 674. Judge Scheindlin also allowed the misstatement claims to proceed because the alleged misstatements were merely intended to camouflage the market manipulation, declaring, in effect that “this is a fair, efficient market, unaffected by manipulation.” *Id.* at 675.

**Fogarazzo v. Lehman Brothers, Inc.:** Motion to dismiss denied

In *Fogarazzo v. Lehman Brothers, Inc.*, No. 03 Civ. 5194 (SAS), 2004 WL 1151542 (S.D.N.Y. May 21, 2004), Judge Scheindlin denied a motion to dismiss even though the facts were very similar to those of *Merrill Lynch*. The complaint, brought by shareholders of RSL Communications, Inc. (“RSL”), alleged that analysts at three firms had falsified their opinions of RSL. Specifically, while RSL issued a series of negative announcements in 1999 and 2000 – and its stock price dropped – the analysts continued to provide RSL with positive ratings. *Id.* at *4-6. Ultimately, RSL’s stock declined to the point that it was de-listed, and each of the three firms then dropped analyst coverage. *Id.* at *6. The court was careful to note that there were no allegations that
the defendants concealed any facts concerning RSL; rather, the plaintiffs merely alleged that despite publicly available negative information, the analysts expressed falsely positive opinions. *Id.* at *11.

Nonetheless, Judge Scheindlin held that the plaintiffs had adequately alleged loss causation. The court explained that loss causation is shown when “(1) the misrepresentation artificially inflated the value of the security, or otherwise misrepresented its investment quality, and (2) the subject of the misrepresentation caused the decline in the value of the security.” *Id.* at *10 (emphasis in original). Here, the subject of the misrepresentations was “the financial health and future prospects of RSL” (*id.* at *11), and though no facts were concealed, that subject still caused plaintiffs’ losses. “[E]ven though the true facts were available to the world to see, by affirmatively opining on the meaning of those facts, the Banks obscured the logical conclusion that RSL was failing.” *Id.* at *11.

Moreover, although Judge Scheindlin expressed uncertainty as to whether the Second Circuit’s price decline approach requires a corrective disclosure, the court concluded that dropping analyst coverage of RSL was a corrective disclosure. “[W]hen the Banks dropped coverage, they essentially conceded (in the eyes of the investing public) that their previous recommendations were mistaken.” *Id.* at *13. Even accepting that this is a corrective disclosure, the court did not address the fact that there was no price decline after coverage was dropped, even though it cites Judge Lynch’s decision in *DeMarco v. Lehman Brothers* – where there had been a 16% stock drop following revelation of the alleged conflict of interest – to support this conclusion.

Clarification of the issues raised by these many Southern District of New York decisions may come in the near future. Plaintiffs in the first few *Merrill Lynch* cases have appealed Judge Pollack’s dismissals to the Second Circuit and briefing was completed as of last month. Oral argument is scheduled for August 12, 2004.
B. 4th Circuit

*Miller v. Asensio & Co.*: Affirming jury award of $0 damages.

In April 2004, the Fourth Circuit issued an opinion in *Miller v. Asensio & Co.*, 364 F.3d 223 (4th Cir. 2004), which appears to indicate that the Fourth Circuit favors the price decline approach to loss causation. The court affirmed a jury verdict finding the defendant liable under Rule 10b-5 for issuing false and misleading statements, but awarding no damages. The court explained that under Rule 10b-5, it is possible for a plaintiff to prove that the defendant proximately caused the plaintiff to suffer a loss, but be unable to show the amount of the damage for which the defendant, as opposed to some other cause, was responsible. *Id.* at 232-33. In that scenario, the appropriate ruling is to find liability, but award no damages. *Id.*

The interesting portion of the opinion for loss causation purposes is the court’s discussion of how the inquiry of proximate causation differs from the calculation of damages. In explaining how the proximate causation inquiry functions, the court cites with approval, and quotes at length, two of the founding decisions of the price decline approach: *Robbins* and *Semerenko*. *Id.* at 232.

*PEC Solutions*: Motion to dismiss granted.

The Eastern District of Virginia applied the price decline approach in *In re PEC Solutions, Inc. Sec. Litig.*, No. 1:03cv331, slip op. (E.D. Va. May 25, 2004). In that case, PEC’s stock price declined following a March 14, 2003 announcement that future earnings would be lower than expected. Plaintiffs alleged that PEC had previously artificially inflated its stock price by withholding material information about problems with a large government contract, but this contract was not discussed in the company’s March 14, 2003 announcement. Judge Lee dismissed the complaint on, *inter alia*, loss causation grounds, because “[p]laintiffs never mention how the Defendants’ alleged misrepresentations led to a fall of the stock price. A conclusory statement that
the stock price fell as a result of a company’s guidance is not enough to show that the decline in the stock price was due to a defendant’s fraud or misstatements.” *Id.*, slip op. at 28.10

C. **5th Circuit**


In April 2004, the Fifth Circuit issued an opinion clarifying its rules governing the fraud-on-the-market doctrine, as well as loss causation. In *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657 (5th Cir. 2004), the court affirmed in part and vacated in part a summary judgment grant in favor of the defendants. The district court had granted the defendants summary judgment because, it concluded, the evidence showed that none of the challenged statements had actually caused a statistically significant increase in the price of the defendant’s stock, and none of the corrective disclosures had caused a statistically significant decline.

The Fifth Circuit held that to invoke the fraud-on-the-market doctrine, a plaintiff must show that the alleged misstatements actually moved the market. *Id.* at 663. This can be shown either through proof that the false statements caused the stock price to increase, or by proof that a corrective disclosure caused the stock price to decline. *Id.* at 665. However, in the latter instance, Plaintiffs must demonstrate: (1) that the negative “truthful” information causing the decrease in price is related to an allegedly false, non-confirmatory positive statement made earlier and (2) that it is more probable than not that it was this negative statement, and not other unrelated negative statements, that caused a significant amount of the decline.

*Id.* at 666. Thus, when the plaintiff relies on a corrective statement, analysis of the two causation elements merge.

10 Wilson Sonsini Goodrich & Rosati (including two of the authors – Lyle Roberts and Nicholas Porritt – of this article) represented the defendants in the PEC Solutions case.
In applying this test to the facts before it, the court affirmed summary judgment as to most of the challenged statements because they did not move the market, and the corrective disclosures were not sufficiently related. *Id.* at 666-68. As to a few of the statements concerning the defendant’s financial status, however, the court reversed the district court’s grant of summary judgment. Although the statements did not cause a stock price increase, the corrective disclosures – stating that revenues would be below projections – did cause a sufficient decline. *Id.* at 669. Moreover, although the plaintiffs failed to present evidence that these declines resulted from the corrective disclosure, as opposed to other news, the court stated that it was “persuaded the news that a company’s revenue will be 66% below estimates satisfies the plaintiffs’ burden.” *Id.*

**EDS**: Motion to dismiss denied.

In January 2004, Judge Davis of the Eastern District of Texas denied a motion to dismiss in *In re Electronic Data Sys. Corp. Sec. and “ERISA” Litig.*, 298 F. Supp. 2d 544 (E.D. Tex. 2004). In that case, EDS’ stock price dropped by nearly $20 per share after EDS announced that its expected revenues would be down by 2-5%, in contrast to an earlier projected increase of 4-6%, and its earnings per share would be $.60 lower than projected. In their complaint, the plaintiffs challenged a number of EDS’ statement regarding a contract with the Navy. EDS moved to dismiss on loss causation grounds because the earnings warning that triggered the stock drop did not mention that contract. The court rejected this argument, stating that “[d]efendants cannot escape liability for fraud simply by not admitting the fraud.” *Id.* at 560-61. The court noted that “[p]laintiffs have connected at least a portion of the stock price fall to the NMCI Contract by their allegations and with evidence that market analysts connected the two.” *Id.* The court refused to resolve on a motion to dismiss whether the stock price fall was actually due to other factors. *Id.*
D. 6th Circuit

**D.E. & J. L.P. v. Conaway:** Motion to dismiss granted.

The Sixth Circuit may not have formally joined either camp in the loss causation debate, but Judge Rosen of the Eastern District of Michigan issued an opinion squarely adopting the price decline approach, largely relying upon unreported Sixth Circuit decisions. In *D.E. & J. L.P. v. Conaway*, 284 F. Supp. 2d 719 (E.D. Mich. 2003), the court dismissed a securities class action against several former Kmart executives and Pricewaterhouse Coopers. The complaint alleged that the defendants misled Kmart investors in 2000 and 2001 prior to the company’s bankruptcy. Citing, *inter alia*, Judge Pollack’s decision in *Merrill Lynch*, Judge Rosen held:

Plaintiffs here have not alleged in their Complaint the requisite “causal nexus” between the alleged misrepresentations of the Defendants and the economic harm they suffered as a direct result of the alleged fraud. Rather, Plaintiffs take the position that to allege loss causation, a plaintiff need only show that he or she purchased a stock at a price that was artificially inflated by Defendants’ misrepresentations. Such an allegation satisfies only the “transaction causation” prong of the causation requirement. As discussed above, 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. (citations omitted).

*Id.* at 749.

E. 8th Circuit

**Gebhardt v. ConAgra Foods, Inc.:** Adopting the purchase price disparity approach.

The Eight Circuit affirmed its adherence to the purchase price disparity approach in *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824 (8th Cir. 2003). Plaintiffs alleged that the company had engaged in fraud by permitting its United Agri Products subsidiary to prematurely recognize revenue from sales where the delivery of the goods had not yet taken place. The Eighth Circuit found that “the problem was mostly one of having the money attributed to the wrong year, as opposed to
not having ever made the money at all.” *Id.* at 827. As a result, “ConAgra’s income, before taxes, was reduced by $111 million for the years 1998 through 2000, while its income for 2001 was increased by $127 million.” *Id.* When the restatement was announced in May 2001, the stock price dropped from $20.61 to $20.07. It quickly recovered, however, and began to trend higher. *Id.*

The district court dismissed the case on two bases. First, the lower court noted that the amount of earnings misrepresented was merely 0.4% of ConAgra’s total revenues during the years in question. The lower court concluded that “[a] reasonable investor with complete knowledge of the UAP accounting issues would have realized that ConAgra’s overall earnings were basically unaffected by any of those issues.” *Id.* at 828. Second, the lower court held that the plaintiffs’ pleadings failed to allege loss causation. The alleged misrepresentations were immaterial and the company’s stock price was barely affected by the announcement of the restatement. *Id.*

The Eighth Circuit disagreed with both conclusions. On the issue of materiality, the appellate court found that focusing on the percentage of total revenues misstated was insufficient. As a result of its revenue recognition problems, ConAgra overstated its net income for 1999 and 2000 by 8%. A discrepancy of that magnitude is not immaterial as a matter of law. *Id.* at 830-31. As for loss causation, the Eighth Circuit found that because the alleged misrepresentations were material, the plaintiffs can “invoke the fraud-on-the-market theory and assume that the misrepresentations inflated the stock’s price.” *Id.* at 831. Even though the stock price did not decline when the restatement was announced, the appellate court declined “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.” *Id.* at 832.
F. 9th Circuit

*Broudo v. Dura Pharm., Inc.*: Adopting the purchase price disparity approach.

The Ninth Circuit also strongly reaffirmed its adherence to the purchase price disparity model. In *Broudo v. Dura Pharm., Inc.*, 339 F.3d 933 (9th Cir. 2003), the defendants allegedly made misleading statements about, among other things, the clinical trials necessary to obtain new drug approval from the FDA for Dura’s Albuterol Spiros delivery device for asthma medication. On February 24, 1998, Dura revealed that it expected lower-than-forecast 1998 revenues and 1998 earnings per share, but did not make any disclosures about its Albuterol Spiros delivery system. The February 24 announcement caused Dura’s stock price to decline by 47%. *Id.* at 936. It was not until November 1998, nearly nine months after the end of the class period, that Dura announced the FDA had “found the Albuterol Spiros device not approvable due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns.” *Id.* The district court found that the plaintiffs had failed to properly plead loss causation for his claims based on misleading statements concerning the Albuterol Spiros device because the complaint did “not contain any allegations that the FDA’s non-approval [of the Albuterol Spiros device] had any relationship to the February price drop.” *Id.* at 937.

The Ninth Circuit reversed. It held that it was unnecessary for the plaintiffs to plead “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.” *Id.* at 938 (citation omitted). Rather, in a “fraud on the market case,” loss causation “merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause.” *Id.* The court reasoned that the plaintiff’s “injury happens when the stock is purchased at an inflated price.” *Id.* What happens to the stock price later is simply irrelevant.