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Loss Causation: Dealing with Dura *During the Market Downturn*

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In 2005, the United States Supreme Court issued a seven-page opinion that reshaped the world of securities litigation. In *Dura Pharmaceuticals, Inc. v. Broudo*,[1] the Supreme Court enhanced the "loss causation" requirement applicable to at least some securities plaintiffs, specifically those class action plaintiffs alleging "fraud on the market" cases under Securities and Exchange Commission Rule 10b-5. For such plaintiffs, the Supreme Court established that a plaintiff's evidence of damages must consist of more than proof that the plaintiff purchased the security at a price that was inflated by a defendant's misrepresentation or omission.

The Court held that proof of an inflated price did not demonstrate the requisite "loss causation, *i.e.,* a causal connection between the material misrepresentation and the loss."[2] The Court concluded that a plaintiff has no loss "at the moment the [purchase] transaction takes place"; that a plaintiff must show that the defendant's misrepresentation was a "proximate cause" of plaintiff's subsequent loss; and that a decline in the price of a fraudulently-inflated security may not have been caused by the fraud but instead may have been due to non-fraud-induced "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events."[3]

With the current credit crisis and market downturn, investors now face the most dramatically "changed economic circumstances" and "changed investor expectations" in several decades. For most companies, the "industry-specific" facts have undergone a sea change. Against this background, stock and bond prices are declining and, in some cases, cratering. In this climate, it is appropriate to explore how a defrauded investor can, given *Dura*, nonetheless pursue a defendant that defrauded the investor into making a purchase at an inflated price.

Dura's Reasoning Failure

In grappling with *Dura*'s meaning, it may be helpful to face the fact that the decision is a debacle in the field of law and economics. This recognition may make it marginally easier to understand the follow-on rules implemented by the lower federal courts. It may also lead one to recognize that many institutional plaintiffs should pursue state law or non-class action litigation that should allow courts to apply better-reasoned legal rules than those that have followed in *Dura*'s wake.

The *Dura* Court's analysis hinges on its brief summary of the nature of "loss" for a defrauded investor:

> [A]s a matter of pure logic, at the moment the [fraudulently-induced] transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value. Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong. Shares are normally purchased with an eye toward later sale. But if, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss. If the purchaser sells later after the truth makes its way into the marketplace, an initially inflated purchase price *might* mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events, which taken separately or together account for some or all of that lower price.[4]

As Professor Merritt Fox of Columbia Law School detailed in an article soon after the *Dura* decision, this analysis of the nature of "loss" is flawed.[5] Under most securities laws, and as at least one alternative measure in cases of common law fraud, damages are governed by an out-of-pocket measure determined at the moment of a fraudulently-induced purchase. Under this measure, when an investor pays an inflated price

that exceeds the security's actual value, the investor has suffered a measurable out-of-pocket loss. The investor may not know she has been scammed, but she is holding an instrument that is truly worth less than the price she paid. To avoid this basic proposition, the Supreme Court resorted to the notion that "what everyone else also don't know can't hurt you"—after all, until everyone knows the truth, the investor can sell the fraudulently-inflated security for the fraudulently inflated price. As Professor Fox pointed out, this notion is half-baked. If the "hot potato" security gets passed on to a second investor before the truth impacts the security's value, duplicate damages can be avoided by allowing the second investor rather than the first to recover for the injury because it is the second investor who realized the damages. Indeed, as the Professor noted, the case law implemented this rule long before *Dura*.[6] Thus, the Supreme Court identified a problem that had long been solved by a different legal rule and used it to manufacture a new "loss causation" dilemma—out-of-pocket damages that exist at (and are measured at) the moment of purchase are deemed not to exist because the damages might be realized by an unsuspecting transferee.

Worse yet, as Professor Fox explained, the Supreme Court ignored basic principles of valuation and simply pretended that the fraudulent inflation might somehow never cause an injury in a later sale. If a security's price is inflated by a misrepresentation or omission, when "the truth makes its way into the market, the initially inflated price will inevitably result in a loss. Whether it is the original purchaser of the [security] or some later one, some investor will be unambiguously economically disadvantaged because the misstatement inflated his purchase price."[7] The "efficient market hypothesis" that underlies much of modern finance theory and securities law "assures us that once the truth comes out, the price will no longer be inflated."[8]

Brevity is often a virtue. But not when it results in the kind of incomplete and weak analysis displayed in *Dura*. The decision, nonetheless, stands as the law of the land—at least until such time as Congress is persuaded to fix this mistake.[9]

What Dura Requires: Methods of Demonstrating Loss Causation

Beyond establishing that a plaintiff needs to provide evidence of something more than initial price inflation to demonstrate loss causation, the *Dura* decision provides little guidance as to what is required. In 2007, the United States Court of Appeals for the Seventh Circuit issued a decision that summarized the two principal methods that courts have accepted post-*Dura* as sufficient proof of loss causation.[10]

The most frequently accepted method of proving loss causation is through evidence that the price of the security declined upon the market's learning of the deception. Thus, one could say that this method requires proof that the out-of-pocket loss was real through a demonstration that the revelation of the truth resulted in a market adjustment. Applied most rigorously, this alternative requires a plaintiff to hire an expert to do an event study that identifies particular dates on which particular previously-hidden information was disclosed, with the study demonstrating that the security's price declined in response to those disclosures.

Unfortunately, in real life, things are rarely so neat. One cannot always readily identify moments of disclosure of particular information. The more frequent scenario involves a secretly-ill company that produces a gradual stream of poor results—results that would have been predictable if an investor knew the company's true condition. As the poor results are revealed, the value of the company's securities declines—but all without a definitive moment when the company's true underlying condition was definitively revealed to the market. The absence of particular moments of disclosure renders an event study difficult, if not impossible.

The second, and less commonly accepted, method of demonstrating loss causation is through proof of "materialization of the risk." This method requires the plaintiff to demonstrate that the hidden truth (the "risk") caused the company's poor financial results (the "materialization") and ultimately the decline in the value of the security. Under a "materialization of the risk" analysis, it does not matter if the truth remained hidden even long after the decline in value.[11] As a simple example, suppose a company represented that it had two factories, each capable of producing 500 cars a month. In reality, the company has only one factory that could produce 300 cars a month. After selling stock based on the misrepresentation, the company produces 300 cars a month and profits less than one-third the amount it would have been able to produce with the represented factories. When these low profits are reported to a market that was expecting much larger profits, the stock's price declines significantly. The truth is not yet out, but the decline in the stock's price has been caused by the concealed truth. A plaintiff who demonstrates such facts has proven loss causation via "materialization of the risk." Perhaps unsurprisingly, when there has been a major corporate disaster (*e.g.*, Parmalat or WorldCom) where the full truth was revealed long after the collapse of the allegedly fraud-riddled company, courts tend to reject the need for an event study and instead turn to the "materialization of the risk" method.[12]

The "materialization of the risk" theory can prevail even when the causation issue is denominated "proximate cause" rather than "loss causation." The author was part of the successful trial and appellate team in *OCM Principal*

Opportunities Fund, L.P. v. CIBC World Markets Corp., which was resolved by the California Court of Appeal in late 2007.[13] In that decision, the Court determined that the notion of "loss causation" was inapplicable because Plaintiffs claims were brought under state securities laws and the common law.[14] The Court nonetheless applied a tort law notion of proximate cause. In language similar to that used by the courts that have applied the "materialization of the risk" method, the Court in *OCM Principal* noted that an official Comment to Section 549 of the Restatement (2d) of Torts establishes that a stock promoter is liable even for price declines caused in part by "subsequent changes in financial or business conditions" where "if the corporation had had the capital and assets that it was represented as having, its chance of surviving the depression would have been greatly increased."[15] *OCM Principal* involved the collapse of Renaissance Cosmetics, which defendants asserted had occurred during a time of industry-wide adverse changes in the wholesale fragrance industry. The Court concluded that the evidence demonstrated that Renaissance Cosmetics would not have collapsed if it had actually possessed the assets represented in the fraudulent offering memorandum and that plaintiffs had thereby shown that Renaissance's collapse "had the requisite 'connection with or relation to the matter[s]' that CIBC had fraudulently misrepresented and concealed"—even though the true facts of Renaissance's condition at the time of the offering memorandum were revealed long after the company's collapse.[16]

Defeating the Dura Defense

Given the recent economic downturn, defendants will be prominently invoking *Dura* in efforts to defeat claims of defrauded plaintiffs. After all, if similar securities declined by large amounts, how can a plaintiff demonstrate loss causation? To take a relatively recent example involving an industry-wide downturn, the defendants in the 2007 *Ray v. Citigroup* decision successfully invoked *Dura* based principally on a showing that while the assertedly-inflated stock had declined 98.75%, its competitors stocks had declined 98.9%, 98.39% and 94.35% in the same time period.[17]

There are at least two methods to avoid this fate. First, counsel should plead claims that are not subject to a requirement of loss causation or where proof of loss causation is not the plaintiff's burden. Under *Dura*, fraud-on-the-market 10b-5 class action plaintiffs must show loss causation. The case law leaves some uncertainty as to whether loss causation is required of plaintiffs pursuing non-class or non-fraud-on-the-market claims under 10b-5.

While loss causation is not an affirmative element of a claim under Section 11 or Section 12(a) of the 1933 Securities Act, each of these claims is subject to an affirmative defense that allows the defendant to show that the injury is not attributable to the fraudulent conduct.[18] As that concept is analytically analogous, loss causation analysis will likely play a role in the determination of that affirmative defense. However, a plaintiff is far better off in facing this issue as an affirmative defense rather than a requirement of the plaintiff's affirmative case. A plaintiff is unlikely to be defeated at the motion to dismiss stage by a potential affirmative defense.

Other claims are not subject to a loss causation analysis. The decision in *OCM Principal* establishes that *Dura*'s loss causation analysis is not directly applicable to claims under California's common law and state securities laws.[19] While *OCM Principal* required a showing of proximate cause, it appears that the proximate cause hurdle for demonstrating a connection between the realized harm and the fraudulent conduct is at least somewhat lower (or better reasoned) than that imposed by a loss causation requirement.[20]

Beyond an effort to avoid *Dura*'s application, counsel should develop the evidence sufficient to demonstrate "materialization of the risk" and thus prove loss causation. This could involve an analysis of the financial difficulties and decisions that the company faced and potentially expert testimony about how the company would have been able to handle its issues if it had only had the capabilities it was represented to have. The plaintiffs in *Ray* were defeated in part because they lacked such expert testimony.[21] In developing "materialization of the risk" evidence, one should keep in mind the Restatement's example of undisclosed facts that made the company particularly vulnerable to an industry-wide downturn.

Conclusion

It has been four years since the Dura decision. If Congress does not remedy the Supreme Court's illogical rule-making, then defrauded plaintiffs and their counsel need to be alert to, and prepared to deal with, Dura's ramifications—particularly in the midst of a major economic downturn.

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[1] *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 125 S. Ct. 1627 (2005).
[2] *Id.*, 544 U.S. at 342, 125 S. Ct. at 1631.
[3] *Id.*, 544 U.S. at 342–43, 125 S. Ct. at 1631–32.
[4] *Id.*, 544 U.S. at 342–43, 125 S. Ct. at 1631–32 (emphasis added).
[5] Merritt B. Fox, *After Dura: Causation in Fraud-on-the-Market Actions*, 31 J. CORP. L. 829, 862–64 (2005–2006).
[6] *See Blackie v. Barrack*, 524 F.2d 891, 908–909 (9th Cir. 1975) (original purchaser's damages reduced by "the inflation he recovers from his purchaser").
[7] Fox, *After Dura*, 31 J. CORP. L. at 864.
[8] *Id.* at 832, 864 & n.9 ("Other than the inflation in price due to the misstatement, the efficient market hypothesis (EMH) guarantees that the purchase price is a fair one

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