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Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse *Broudo*

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Abstract

The Supreme Court is about to hear Dura Pharmaceuticals Inc. v. Broudo, a case in which the Ninth Circuit significantly liberalized the "loss causation" standards applicable to federal securities litigation. In response to a companion article by Professor Merritt Fox, which favors such a liberalization and even the abandonment of loss causation as a necessary element, Professor Coffee argues that any change in causation standards that permits a plaintiff to escape showing a decline in the security's stock market price attributable to the material misstatement or omission gives rise to perverse incentives, which would likely result in the award of phantom losses that may have been caused instead by other factors, such as a market bubble. More generally, he argues that the securities class action against the corporate defendant in cases of secondary market stock drops appears to serve little legitimate function, advancing neither compensatory nor deterrent ends. Instead, such actions against the corporation (as opposed to actions against gatekeepers, controlling persons or the corporation in the primary market setting) principally effect inefficient wealth transfers among largely diversified shareholders. Given the legal and other transaction costs involved, shareholders appear likely to be net losers from such actions. As a result, he concludes that further minimization of the causation requirement should await policy clarification of the role of the "fraud on the market" action against a non-trading issuer defendant.

Over a quarter of a century ago, Judge Henry Friendly coined the term "fraud by hindsight" in upholding the dismissal of a proposed securities class action.[1] As he explained, it was too simple to look backward with full knowledge of actual events and allege what should have been earlier disclosed by a public corporation in its SEC filings. Because hindsight has 20/20 vision, plaintiffs could not fairly "seize upon disclosures" in later reports, he ruled, to show what defendants should have disclosed earlier.[2]

Today, a parallel concept – "causation by presumption" – is before the Supreme Court, and it too deserves to be rejected. At issue is whether a loss that never actually occurred in the real world – but arguably would have if other events had not intervened or if full corrective disclosure had been made – can support a Rule 10b-5 cause of action against a public corporation. The key problem with such a hypothetical determination of loss involves the limited institutional competence of judges and juries to infer losses.

Generally, markets determine the loss, and the judicial system (judges and juries) allocates it among the parties to a litigation. This makes sense; markets know best what information to value, and the legal factfinder can best make the normative judgments about the defendant's requisite culpability and relative fault.[3]

Yet, under Broudo v. Dura Pharmaceuticals, Inc.,[4] the case now before the Supreme Court, the judicial system (and typically the jury) would potentially determine both. Losses uncorroborated by any form of market reaction to the discovery that material information had been misstated or omitted could be awarded. For example, in the absence of such a market reaction, the jury could determine that the stock price was inflated – even though the market price of the stock either never declined or instead declined for entirely unrelated reasons. Broudo's approach has been formalized by my able colleague Professor Merritt Fox in his companion article. Under his proposed methodology, once "the plaintiff successfully pleads that the misstatement is material, there would be for pleading purposes a presumption that the misstatement inflated the purchase price."[5] This is what I term "causation by presumption," because its net effect is to eliminate any real obligation to show a causal connection between a material misrepresentation or omission and any actual stock market decline. This premise that because material adverse information was not disclosed, the price must therefore have been inflated is, however, highly questionable. That a jury finds a fact to be material does not mean that the market would have given it weight. To say this is not to reject efficient market theory, but only to recognize that the factfinder's conclusion is not the judgment of that market.

More generally, permitting such hypothetical loss determinations without corroboration from any actual market movement expands the role of courts and juries beyond their historical domain (which was to allocate losses that demonstrably existed) and shrinks the role of the market. Ultimately, markets, rather than courts, are better at determining the extent of the loss, if any, that has occurred, even if the market reaction may sometimes mask a possible loss because of offsetting positive and negative developments. Part I of this comment will examine the practical implications of Broudo's approach to causation.[6]

Part II then turns to Broudo's policy implications for securities class actions and shareholder welfare. Rule 10b-5 class actions tend disproportionately to be secondary market class actions in which the defendant corporation has neither bought nor sold its own shares during the relevant period. Within this context, the need for a market corroboration of a loss seems strongest because such a securities class action essentially pits one class of shareholders (those who traded within the class period) against all other shareholders. Inherently, in the secondary market context, such actions generate wealth transfers from the latter class of generally non-culpable shareholders to the former class.

Why we should wish to maximize the number and amount of these intra-shareholder wealth transfers is a question that seems to have escaped serious policy debate. But such a debate is needed because these transfers seem likely to produce net losses in the real world, once the considerable transactions costs extracted by the legal profession are subtracted. Broudo does not create this problem, but it exacerbates it. Thus, although Professor Fox incisively explains the incongruence between traditional reliance theories and the context of secondary trading in an efficient market, his analysis ducks the real policy issue: namely, the legitimacy of maximizing wealth transfers among generally diversified shareholders. Until this issue is placed at the forefront of any policy analysis, discussions of presumptions and burdens of proof merely rearrange the deck chairs on the Titanic.

In fairness to Professor Fox, his doctrinal history is succinct and accurate, and he clearly demonstrates that transaction causation is logically irrelevant to this open market context (and in fact courts have quietly dispensed with it). But his attempt to dispense similarly with loss causation takes him, I believe, a bridge too far. Eliminating loss causation (or replacing it with a presumption) forces the corporate defendant to act as an insurer who must compensate shareholders who traded within the class period for losses that may have only a tenuous relationship with any misrepresentation it made. The cost of such insurance is not only expensive, but it provides no real benefit for diversified shareholders who fall into both classes and thus wind up effectively transferring wealth from one pocket to another (minus considerable legal costs). For all these reasons, little policy justification exists to further liberalize the standards applicable to secondary market Rule 10b-5 litigation against a non-trading issuer.

Part III will turn to doctrinal and statutory issues. The approach of both Broudo and Professor Fox conflict with the methodology that the Supreme Court has laid out for construing Rule 10b-5's contours: namely, as an implied cause of action, Rule 10b-5 must mirror the most closely comparable express cause of action. In fact, the most closely comparable provisions define loss causation so as to focus exclusively on the "depreciation in value" of the security, thereby implying that initial price inflation at the time of purchase without subsequent "depreciation in value" is insufficient.[7] In addition, the Private Securities Litigation Reform Act of 1995 (the "PSLRA") makes proof of loss causation mandatory in a Rule 10b-5 action, and it clearly assigned the burden of proof on that issue to the plaintiff. This allocation of the burden is frustrated, however, if courts recognize a presumption of causation based only on a proper pleading of materiality.

Current law also draws an entirely sensible distinction between the primary and secondary market contexts, placing the burden on the plaintiff of proving loss causation in the secondary market context, but shifting it to the defendant to disprove loss causation in the primary market context.[8] This distinction would be frustrated if merely pleading that a misstatement "inflated" the issuer's stock price could suffice to satisfy the loss causation standard in the secondary market context (because such proof will clearly not work in the primary market context).[9]

I. What's At Stake in Broudo

In Broudo, the defendant Dura Pharmaceuticals announced lower than forecast earnings in February, 1998 and suffered a very sharp drop in its stock price (47% in one day).[10] This was the only stock price decline that plaintiffs alleged (or that otherwise appears in the record). Plaintiffs did allege, however, that materially false misstatements were made over an approximately nine month period from April, 1997 to January 1998, which preceded the February 1998 earnings surprise. These misstatements related to an asthma medication delivery device that Dura was developing. Ultimately, in November, 1998, Dura announced that the Federal Drug Administration had refused to approve this product, but plaintiffs did not allege that the market declined in response to this announcement.[11]

Although the district court dismissed the complaint in Broudo for failure to plead "loss causation,"[12] the Ninth Circuit reversed, finding that the plaintiff need not plead any causal connection between the misstatement and a subsequent decline in price, but only need plead "that the price at the time of purchase was overstated and sufficient indication of the cause."[13] The Supreme Court granted certiorari on this issue.[14]

Professor Fox believes that the Ninth Circuit got it right. Because the market was efficient, Dura's allegedly false statement "can be presumed to have inflated the price paid for its shares."[15] "Thus," he concludes, "the pleadings are satisfactory as to causation."[16] In short, the plaintiff need only plead price inflation, and not that the stock price subsequently fell. From an economic perspective, Professor Fox's theory is coherent: if you make a material misstatement, it must inflate the market price and so the shareholders purchasing at that inflated price are injured. But from a legal and institutional perspective, this presumption is more suspect, and in any event the law of fraud has never condensed to this simple and skeletal a formula.[17]

Initially, it is important to focus on the incentive effects created by this theory that the plaintiff need only allege price inflation. Under such an interpretation of Broudo, materiality subsumes causation. Once materiality is shown, some price inflation is to be presumed. As a result, the practical impact of this rule would be to give plaintiff's attorneys a strong and seemingly perverse incentive to search the stock market for significant stock price declines and then seek to allege that some material information had been withheld or misstated – even if, as in Broudo, other developments (i.e., the earnings shortfall in that case) seemed to explain better the stock price decline.

To illustrate, assume that Foreign Corporation, whose stock is actively traded in the U.S. market, is suddenly nationalized or simply shut down by its home country, and its price falls from $50 per share to zero. The proximate cause of this loss may seem obvious, but if plaintiffs can plausibly allege that Foreign Corporation had inflated its financial statements so that its true intrinsic value was only $30 per share at the time that class members purchased its stock, then, under Broudo, they can sue for this $20 worth of inflation – even though there is no market corroboration that any misstatement would have had such an impact. To be sure, some allocation of the loss would be necessary between the non-fraudulent causes of the stock price decline and the alleged material misstatements or omissions. But this would not need to be done until one reached the damages stage of the action. In the real world of securities class action litigation, this stage is seldom reached.

The practical impact of eliminating any requirement that the plaintiff plead a causal connection to a subsequent stock decline is that many more cases would survive dismissal at the pleading stage, because the plaintiff's attorney would only have to plead materiality and scienter. At trial, the plaintiff's attorney could plausibly assert that some portion of the stock drop was attributable to the market's discovery of some or all of the undisclosed or misstated material facts (even if most of the stock drop seemed more attributable to a fully disclosed cause). Or, alternatively, the plaintiff could assert that the stock price was still inflated.[18] While Professor Fox makes clear that he would not allow damages without some actual decline in the stock's value, Broudo is far less clear and might allow a recovery even in the absence of a stock market decline.

In practice, the most likely scenario under Broudo would be something like this: A high-tech company fails to disclose that a key patent may not be valid and enforceable because it infringes on that of a rival company. Plaintiffs assert that the stock, which has long traded at $100 per share, is really worth only $70 because of this problem. But before any disclosure is made, all of the company's senior management dies in a crash of their corporate jet, and, without them, this start-up company cannot continue. The stock price falls to $10.[19] Alternatively, there may be no plane crash and instead newspaper stories reveal that the company faces some patent litigation; in response, the market price responds partially, falling only to $90 per share. Still, plaintiffs assert that because the full truth has not been revealed, the stock is still inflated, and its actual value is only $70.

Either way, how should we answer Professor Fox's claim that the shareholders who bought at $100 were truly injured at the time of their purchase by the company's failure to disclose a material problem with its patents and thus they should be able to recover the difference between $100 and the stock's alleged "intrinsic value" of $70 – without showing any market correction attributable to the misstatement or omission? Several different answers can be given that all reiterate the basic theme that the loss here is simply too speculative and indefinite in the absence of any evidence that the market considered the stock to have been overvalued because of the alleged patent problem. First, even if judges and juries simply are competent to determine the materiality of the misstatement, they cannot reliably measure its financial impact in the absence of some market evaluation of the corrected disclosure. Was the material nondisclosure worth $10 or $70? Juries generally do not have a clue. Second, even if material adverse information was not disclosed (as in the foregoing patent hypothetical), material positive information may have also been withheld for proprietary reasons, so that the $100 purchase price did in fact reflect intrinsic value (or even fell below intrinsic value). This is not implausible, because corporations have an incentive to withhold proprietary information from their competitors.[20] Third, the nondisclosure of the patent problem went to a risk that might or might not materialize. In fact, if it had been disclosed, assume that the market price would have sunk temporarily to $70, but ultimately it would have rebounded to $100, or more, when the company won the patent litigation. Why should non-selling shareholders be compensated for only a temporary decline in their corporation's stock price that never affected them?

Finally and most importantly, the stock may have been inflated, but the real cause was a market bubble.[21] The plaintiff shareholders may have purchased in the secondary market in the aftermath of an IPO, when the stock price soared, pushed upward by an overheated market.[22] Thus, the price inflation may not be attributable to any misstatement, even if a material misstatement were made. Hence, to hold the issuer liable on these facts is to make it an insurer for the market's "irrational exuberance." But again, this results in a system of extraordinarily expensive self-insurance for diversified investors, which they clearly would not purchase if given the choice. Endless variations on all these themes can be posed, but the major point here is that the jury's inference of what the market price would have been had the misstatement or omission not been made involves a speculative judgment in which we can have little confidence.

Professor Fox characterizes my objections as "evidentiary" in nature and adds that I appear "to have little trust in the ability of the judge at summary judgment and the jury at trial to deal reliably" with these issues.[23] He then suggests that judges and juries can deal "sensibly" with these issues.[24] This is, of course, an empirical issue. The latest data shows that on a percentage basis few securities class actions are dismissed before trial and that even this low rate has dropped significantly since the passage of the Sarbanes-Oxley Act.[25] While dismissal rates vary significantly by Circuit, in the Second and Ninth Circuits, which have the highest volumes of securities class action litigation, only 8% and

6%, respectively, of all securities class actions were dismissed within two years of the action's filing.[26] In short, even with today's strict rules (in most Circuits) on loss causation, only a low percentage of securities class actions are dismissed, and Professor Fox would liberalize the pleading standard so that even fewer would be dismissed. This is not a small point. Procedurally, courts have only limited opportunities to dismiss an action before trial, and Professor Fox's proposal would eliminate one of these. Nor is summary judgment an adequate substitute, because if there are triable factual issues, the court has no discretion and must let the action proceed to trial.

The differences between Professor Fox and myself may well boil down, on the operational level, to my insistence that procedure counts. From his ex ante perspective, it can be argued that dropping loss causation as a necessary element in the liability equation does not truly change much because the plaintiff still must prove damages. Arguably, the issues that are today addressed in most Circuits under the heading of causation would instead simply be postponed to the later stage at which damages are determined (where the plaintiff would still bear the burden of proof). This might be correct in theory if cases where actually litigated at this damage determination stage, but they are not. Cases that survive pre-trial dismissal tend to be settled. Hence, any proposal to substitute a presumption of causation for the traditional loss causation rule (as Professor Fox proposes) substantially tilts the playing field to the disadvantage of defendants. Delaying the issue of causation until the damages phase realistically means (i) that issue of causation would be at least partially transferred from the court's control to the jury's discretion, and (ii) the defendants would lose their current opportunity for a pre-trial screening of the case by the court. Thus, both in terms of timing and the allocation of responsibility between the judge and the jury, Broudo's rule (and, even more so, Professor Fox's codification of it) are adverse to defendants and will raise the settlement value of securities class actions.

The full scope of the problems that Broudo raises comes into clearest focus only when we consider the prospect that multiple plaintiffs, each relying on different public statements made at different times, could all assert that the corporation's stock price was overvalued because of material misrepresentations made at or prior to the time they purchased – but that this price inflation was never detected (or at least fully corrected) by the market. To illustrate, assume that a large block of shares in Corporation X was purchased at three different times during 2004: (i) by a state public pension fund on April 1, 2004 at a price of $60 per share, which price was allegedly inflated because Corporation X had failed to disclose that it used an improper accounting principle in determining its 2003 earnings (which results had been publicly released at that point); (ii) by a mutual fund on June 1, 2004, also at $60 per share, but a time when Corporation X allegedly knew, but had not disclosed, that it was subject to material environmental liabilities that were likely to be asserted eventually; and (iii) by a hedge fund on October 15, 2004, also at $60 per share, at a time when Corporation X allegedly knew, but had not disclosed, that its principal customer had terminated their long-term exclusive dealing agreement. Throughout this period and thereafter, Corporation X's stock price remains stable at $60 – until April 1, 2005 when it suddenly falls to $40 per share. Each of these investors sues in a different court (two in federal court, and the third in state court), each alleging that the stock price had been inflated at the time of their purchase. Under Broudo, all they need allege is materiality and scienter. Each could win its own proceeding, each potentially recovering the full $20 difference per share (or more, if they convinced the jury that the market had not yet fully corrected the inflation). Even if the defendant introduced persuasive evidence that some extrinsic event (i.e., a change in interest rates or a world crisis) had caused the market decline from $60 to $40 per share, plaintiffs could still reply that the latent price inflation in their case still remained.[27]

Beyond the practical problems in such litigation, the greater problem in applying "efficient market" reasoning to the context of securities litigation may be that lawyers and economists often mean different things when they use the same words. An economist knows that an efficient market will respond to all new material information, incorporating it into price immediately. But a lawyer knows that the concept of "materiality," as it is applied in courts, is broad and liberal. A "material" fact is one as to which:

> "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[28]

This is an expansive test that asks the jury to determine if the information is "important" to a rational decision. Such a definition is broader than the economic definition of materiality, which typically focuses on future discounted cash flows. Facts so found to be material under this legal standard may or may not move the market. Thus, a jury's determination that material facts were not disclosed does not necessarily imply that there has been price inflation; nor should such inflation be presumed. Because the two professions have different understandings of the same term, it is dangerous to presume that a legal conclusion necessarily has real world implication for markets.

II. A Policy Perspective on the Secondary Market Securities Class Action

The context of secondary market trading is very different from that of the primary market in which the corporation issues shares to investors who purchase from it. Because of the long-established separation of ownership and control in the United States, the vast majority of the stock in "public" companies will be owned by dispersed shareholders holding relatively small percentage stakes, with this ownership being divided approximately equally between institutional investors and retail investors. When a securities class action is brought against a public corporation that has not, itself, sold or purchased its securities (i.e., the typical secondary market context), the action is brought on behalf of shareholders (and former shareholders) who purchased the stock during the "class period" (i.e., the time period during which the market was allegedly affected by material misinformation). Any judgment or settlement in this action will be borne by the corporation (and thus indirectly by its current shareholders).[29] As a result, securities litigation in this context inherently results in a wealth transfer between two classes of public shareholders, neither of whom is necessarily culpable. Worse still, even if we assume that fraud was present, the beneficiaries of the fraud are the persons who sold at inflated prices – the selling shareholders – and they escape without incurring any cost when liability is later imposed on their former corporation.

Equally perverse are the implications that flow from the fact that most investors are diversified. Hence, they will belong to both the plaintiff class that sues and the residual shareholder class that bears the cost of the litigation. Either they will have purchased stock at times that are both inside and outside the class period, or, viewed in the aggregate, they will own stock in many corporations that are the subject of securities class actions, sometimes being a shareholder within the class period and sometimes not. As a result, at least in the aggregate, diversified investors are making wealth transfers to themselves, shifting money, as it were, from one pocket to the other – minus, of course, the considerable transactions costs that both sides pay to the legal profession. Indeed, if the legal and other costs borne by the corporation are added to the fees and expenses received by the plaintiff's attorney, this sum on average may well exceed the net recovery to the class.[30] At a minimum, it is clear that recovery rates in securities class actions are extremely modest: 2.8% of investor losses in 2003, up from 2.7% in 2002.[31] In short, as a mechanism for delivering compensation, securities class actions are far from successful and may inflict increased compensatory losses on shareholders.

This is not to deny that there could be deterrent benefits from such class actions,[32] but again these benefits should not be idealized or assumed. Insurance typically protects the individual defendants (and often the corporation as well), and this cost again falls on shareholders. Also, if only 2.7% to 2.8% of investor losses are recovered on average, this cost may be easily absorbed by those who have an incentive to inflate the company's financial statements. Most importantly, for deterrence to work, the costs must fall either on the culpable or at least on those who are the best cost avoiders – that is, those who can take effective precautions to minimize the risks. As a practical matter, this means that actions directed against corporate managers, controlling shareholders, auditors, underwriters or other gatekeepers should have some desirable deterrent effect, but when the liability simply falls on the corporation, as the residual risk bearer, the deterrent effect is dissipated.

Finally, there is the problem of error and its costs. When liability is imposed for a loss that was not causally related to a misstatement or omission made by the defendant, the law generates only an unfocused deterrence, and a windfall is awarded to one class of shareholders (typically, the selling shareholders) at the expense of other shareholders.

Such mistakes are not costless to shareholders, because the defendants who pay will demand a risk premium in the future before they again serve as an auditor, underwriter or other gatekeeper. Also, such deterrence may induce overly conservative financial reporting and/or earnings management that is intended to reduce stock price volatility and thereby minimize the risk of future liability.

For these reasons, I find Professor Fox's analysis too facile when he argues that fraud-on-the market actions "deter corporate misstatements" and thereby increase "share price accuracy."[33] To be sure, they could do so, but the impact of his proposal to drop the loss causation requirement may be more to unfocus deterrence. To the extent that causation is presumed based only on a showing of materiality, the likelihood grows that cases will settle for substantial recoveries where the actual cause of the stock market decline was unrelated. The costs of these settlements would fall like a tax on all shareholders, and such unfocused deterrence may do more harm than good. No policy rationale seems discernible that justifies liberalizing the standards applicable to causation in order to encourage this type of litigation (as opposed to actions against the truly responsible actors).

III. The Battle in the Doctrinal Trenches: How the Court Is Likely to Rule

Although Professor Fox and I have debated loss causation on an abstract level, the Supreme Court will likely resolve this issue on a far more pedestrian and doctrinal level, following an approach that it has laid out in earlier decisions. As the Court noted in Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson,[34] Rule 10b-5 is a judicially fashioned, implied cause of action, one that Congress never really enacted. In such a context, the Court concluded, the scope and contours of this implied cause of action must parallel the nearest similar express cause of action.[35] In Lampf, Pleva, the Court found Sections 9 and 18 of the Securities Exchange Act of 1934 to constitute the closest "comparable express remedial provisions," and thus it looked to their statutes of limitations to determine the applicable statute of limitations for Rule 10b-5.

A brief examination of these two sections shows that both also contemplate that a plaintiff must prove loss causation. For example, Section 18 expressly authorizes a suit to be brought for a misleading statement in an SEC filing, but only by a person "who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such a statement, for damages caused by such reliance …."[36] This language seems to require both traditional reliance and that the stock price be "affected" by the misstatement.[37] Finally, because Section 18 limits recoverable damages to the "damages caused by such reliance," it expressly requires a causal connection. But this language may not answer all questions. If the stock price was inflated by a misleading statement and has not fallen in response to any corrective disclosure, the plaintiffs will predictably claim that they have suffered "damages caused by such reliance" on the theory that the price inflation represents their "damages". That such latent inflation constitutes recoverable "damages" seems dubious to me, but the statutory language is at least susceptible to divergent readings.

If Section 18 does not clearly resolve the issue of whether alleging price inflation is sufficient, it may answer a much more important question, because the express language of Section 18 permits the Court to reconsider Basic v. Levinson,[38] which established the current doctrinal formula that the plaintiff in an efficient market relies on the "integrity of the price set by the market."[39] Because Section 18 expressly requires actual reliance on the statement, itself, it follows that, if Section 18 is the appropriate template to which Rule 10b-5 must conform, then reliance on the "integrity of the price set by the market" would be insufficient to establish causation for Rule 10b-5 purposes.[40]

Section 9 of the Securities Exchange Act of 1934 also contains similar language that requires that the plaintiff purchase or sell the "security at a price which was affected by such act or transaction."[41] Again, this language arguably could be read to cover price inflation without a subsequent market correction (i.e., the facts of Broudo), but Section 9(e) does limit the damages recoverable to the "damages sustained as a result of any such act or transaction."[42] If the market has not corrected, it seems more questionable here than under Section 18 that the holder of stock at an inflated price has "sustained" any damages.[43]

In any event, the issue of loss causation under Rule 10b-5 is more directly addressed by the PSLRA, which added Section 21D(b)(4) to the Securities Exchange Act of 1934. It provides:

> (4) Loss Causation. – In any private action arising under this title, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages.[44]

This provision clearly assigns the burden of proof on loss causation to the plaintiff. Hence, Professor Fox's view that courts should create a presumption of causation based on a proper pleading of materiality reverses Congress's allocation of the burden of proof. On the other hand, the above provision does not clearly state that proving price inflation is insufficient or that there must be a subsequent price decline following corrective disclosure.

Still, Section 21D(b)(4) clearly intends to refer to an established doctrine called "loss causation." The contours of this established doctrine are clearly set forth in Section 548A of the Restatement (Second) of Torts, which states that:

> "one who misrepresents the financial condition of a corporation in order to sell its stock will become liable to a purchaser who relies upon the misinformation for the loss that he sustains when the facts as to the finances of the corporation become generally known and as a result the value of the shares is depreciated on the market."[45]

Clearly, this definition requires a market correction and is not satisfied simply by the claim that the stock price was inflated at the time of purchase.[46]

Two last statutory arguments may be more dispositive. First, Section 12(b) of the Securities Act of 1933 was added by the PSLRA at the same time as Section 21D(b)(4) was added to the Securities Exchange Act of 1934.[47] It expressly disallows from the damages recoverable under Section 12 "any portion or all of the amount recoverable … other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication … not being true …."[48] In short, only the "depreciation in value," not the original price inflation, can be recovered. Of course, Section 12 of the 1933 Act is addressing the primary market, not the secondary market addressed by Rule 10b-5 and Section 21D(b)(4). Yet, it seems self-evident that stricter standards should apply in the latter case where the defendant did not trade and is sued as a de facto insurer. After all, in both Sections 11 and 12 of the 1933 Act, the two primary market anti-fraud provisions, Congress placed the burden of disproving loss causation on the defendant,[49] while in Section 21D(b)(4), which applies to Rule 10b-5, it squarely places that burden on the plaintiff. Although the burden of proof is different between the loss causation provisions in the two statutes, there is no reason to believe that Congress wanted the concept of loss causation to be substantively different in the two statutes.[50] If anything, Congress wanted loss causation to be a greater barrier to a plaintiff's recovery under the 1934 Act than under the 1933 Act, which is why it assigned the burden of proof to the plaintiff under the 1934 Act. It would frustrate this intent, and indeed reverse the relative significance of the loss causation provision in the two statutes, if loss causation were defined not to require a post-purchase "depreciation in value" under the 1934 Act. Hence, Section 12(b) of the Securities Act of 1933 should be read in pari materia with Sections 21D(b)(4) of the Securities Exchange Act of 1934.

A second statutory argument flows out of Section 21(D)(e) of the Securities Exchange Act of 1934, which was also added by the PSLRA in 1995, and which places a ceiling on damages so that they may not exceed the difference between the purchase price paid by the plaintiff (where the plaintiff is a buyer):

> "and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market."[51]

This language was expressly drafted to limit damages under Rule 10b-5 when the stock price rebounds after an initial decline (as it did in Broudo).[52] Clearly, it assumes that there will be a market correction before there can be liability and then seeks to exclude short-term market corrections (probably because it considered them to be more the product of market volatility than actual fraud). Although this provision's intent was to deny damages when there is an immediate price rebound, this language logically also precludes liability when there is no decline (even if the stock price remains "inflated").[53]

Conclusion

When it is decided, Broudo could resolve a lot or only a little. It could reconsider Basic v. Levinson, which could be significantly curtailed in the light of the PSLRA and Lampf, Pleva.[54] Or, the Court could simply accept the position of Solicitor General that the plaintiff must plead and prove some post-purchase decline in value of the security in order to satisfy loss causation. The Solicitor General's position is extremely modest because it requires only that "the inflation in the price of the security attributable to the misrepresentation was eliminated or reduced."[55] That the inflation only need be "reduced" requires very little, and the Solicitor General's brief even argues that "a drop in the stock price may not be a necessary condition for establishing loss causation in every fraud-on-the-market case."[56] Surprisingly, it goes even further to suggest that the "inflation attributable to a misrepresentation might be reduced or eliminated even if there were a net increase in price."[57]

If this is all that the decision holds, its impact will be very modest indeed. Instead, the Court should rule that because Section 12(b) of the 1933 Act and Section 21D(b)(4) of the 1934 Act are to be read in tandem, there must be a stock price decline and only "depreciation in value" attributable to a material misstatement or omission can be recovered under Rule 10b-5, at least in the secondary market context of a company traded in an active securities market.[58]

The debate over Broudo and loss causation also shows the dangers in a shotgun marriage of law and economics. Procedure counts, and its goals and concerns tend to be excessively discounted by a purely ex ante approach to law and litigation. In particular, the concept of materiality means different things to lawyers and economists. Plugging a jury's legal conclusion that an omitted fact was material into the framework of efficient market theory makes little sense. Preserving judicial discretion and pre-trial screening of cases makes more sense, and the traditional loss causation doctrine does that, at least to a degree. Ultimately, the issue that most needs informed debate is the issue that will probably be ignored in the eventual Broudo decision: the legitimacy of making the public corporation an insurer for market declines in open-market trading cases where the corporation, itself, has not traded.

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1 See Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978).

2 Id.

3 These are the critical decisions for the factfinder in Rule 10b-5 litigation. Did the defendant act with the requisite scienter? What "percentage of responsibility" does the defendant bear in proportion to others? See Section 21D(f)(2) of the Securities Exchange Act of 1934 (mandating proportionate liability unless the defendant had actual knowledge of the misstatement). 15 U.S.C. 78u-4(f)(2).

4 339 F.3d 933 (9th Cir. 2003), cert. granted, 2004 U.S. LEXIS 4605 (June 28, 2004). Broudo did not come from out of the blue. It follows an earlier Ninth Circuit decision that also held that damages could be measured at the time of the purchase transaction and did not require a subsequent decline for a loss to be sustained. See Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996). But see cases cited infra at note 17 (holding that time of purchase price inflation is insufficient).

5 See Merritt Fox, Demystifying Causation in Fraud-on-the-Market Actions, _ Bus. Law. _ at [20] n. 46.

6 The topic of causation is the source and subject of endless debate in academic legal circles, particularly as it relates to tort law (as it does here). See, e.g., H.L.A. Hart & T. Honore, CAUSATION IN THE LAW (2d ed) (Clarendon Press 1985); L. Green, The Causal Relation Issue in Negligence Law, 60 Mich. L. Rev. 543 (1962). Hopefully, the Supreme Court will resolve this issue before academics can muddy these waters further.

7 See text and notes infra at notes 47 to 52.

[8] See text and notes infra at notes 48 to 49.

[9] As discussed infra, Sections 11(e) and 12(b) of the Securities Act of 1933 disallow losses other than the "depreciation in value" of the security attributable to the misstatement. An "inflated" stock has by definition not depreciated, and only the decline can be recovered under these sections. See text and note infra at note 49.

[10] See Brief for the United States As Amicus Curiae Supporting Petitioners in Dura Pharmaceuticals, Inc. v. Broudo (September, 2004) (hereinafter, "Brief for the United States") at p. 2.

[11] According to the amicus brief for the United States, Dura's stock price fell after the November, 1998 disclosure from $12 3/8 to $9 3/4. However, within twelve trading days, Dura's stock price rose above the pre-announcement price to approximately $12 1/2. See Brief for the United States at p. 3. Plaintiffs did not allege any damages because of this decline. Professor Fox suggests that this may have been an oversight on their part. More likely, however, plaintiffs omitted any such reference because of the impact of the Private Securities Litigation Reform Act of 1995, which disallows short-term stock losses when the stock price rebounds. See Section 21D(e)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4(e), (requiring that damages not exceed the difference between purchase price and mean trading price over the 90-day trading period "beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market"). This language also seems to require a corrective disclosure and a downward market movement as a precondition to damages, thus implying that price inflation alone is insufficient. See text infra at note 51.

[12] In re Dura Pharms. Inc. Sec. Litig., 2000 U.S. Dist. LEXIS 15258 (S.D. Cal., July 11, 2000).

[13] Broudo, 339 F.3d at 938.

[14] The Brief for the United States in Broudo defines the issue before the Court as: "Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price." Id. at p. I. The Solicitor General answers this question in the affirmative but would under some circumstances permit a loss uncorroborated by any market movement to suffice. I believe this is a fairly weak compromise. See text and notes infra at notes 55 to 57.

[15] See Fox, supra note 5, at [38].

[16] Id.

[17] Even in Basic v. Levinson, 485 U.S. 224 (1988), the Court did insist that "reliance is an element of a Rule 10b-5 cause of action" and that the plaintiff must demonstrate "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." Id. at 243. Cases in a number of Circuits, both before and after Broudo, have reached contrary results, finding that a pleading of price inflation alone is insufficient to plead loss causation. See, e.g., Emergent Capital Inv. Mgmt., LLC v. Stonepath Group Inc., 343 F. 3d 189, 198 (2d Cir. 2003); Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir 2000); Robbins v. Koger Props. Inc., 116 F.3d 1441, 1448 (11th Cir. 1997). The Restatement (Second) of Torts also takes a contrary approach in its definition of the requisite element of loss causation. See infra at notes 45 to 46.

[18] Admittedly, the plaintiff would be more rational in such a setting simply to sell his inflated shares before they fell in value, but an indexed institutional investor might claim that it needed to hold the stock to maintain a diversified portfolio.

[19] This example roughly corresponds to the example given in Restatement of Torts, Section 548A, comment b.

[20] This point has been much emphasized by some commentators. See Edmund Kitch, The Theory and Practice of Securities Disclosure, 61 Brook. L. Rev. 763, 772 (1995).

[21] The word "bubble" – or its politer euphemism, "irrational exuberance" – does not appear in Professor Fox's article because it is not recognized by the lexicon of efficient market theory. Nonetheless, some financial economists assign it considerable weight in explaining investor behavior. See Robert J. Shiller, IRRATIONAL EXUBERANCE, 173-90 (2000).

[22] Rule 10b-5 will be the plaintiff's remedy of choice in this context, because damages under Section 11(e) of the Securities Act of 1933 are cut off at "the price at which the security was offered to the public" (i.e., the original offering price in the IPO). See 15 U.S.C. §77k(e). Hence, there will be no damages under §11 unless and until the price in the secondary market drops below the initial offering price, which often does not happen. To this degree, Section 11 is "bubble-proof," but Rule 10b-5 is not.

[23] Fox, supra note 5, at [29].

[24] Id.

[25] National Economic Research Associates ("NERA") regularly tracks the trends and status of securities class action litigation and publishes regular reports. Their most recent is Elaine Buckberg, Todd Foster, and Stephanie Planich, "Recent Trends in Securities Class Action Litigation: 2003 Early Update" (NERA February 2004). It finds that "there have been one-third fewer dismissals since SOX, a statistically significant drop compared to the prior pace." Id. at 4.

[26] Id. at 5. This statistic is only for the first two years of the action's life, but if a securities class action survives that long, settlement becomes much more likely.

[27] If only in a footnote, some skepticism needs to be expressed here about this idea of a loss that the market never discovers. An ancient maxim of Wall Street is that "A bargain that stays a bargain is no bargain." But the other side of this coin should be that "A loss that never materializes is no loss."

[28] See Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Industries Inc. v. Northway, Inc., 426 U.S. 438, 448-449 (1976)). In addition, the Court added that "there must be a substantial likelihood that the disclosure … would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Id. at 232.

[29] The corporation may well be partially insured for such liabilities. But, the cost of insurance is again borne by all the shareholders.

[30] While there are many studies of the plaintiff's legal fees and expenses in securities litigation, I am aware of none that add in the defendants' costs in order to estimate the true net recovery, if any, for shareholders as a class. Additional costs that might go into this equation include the cost of liability insurance, the additional risk premium that auditors may charge because of liability risks, the diverted time of management, and the imputed time of in-house counsel.

[31] See Buckberg, Foster, and Planich, supra note 25, at 8. The highest recovery rate for investors was apparently 7.2% in 1996. Id.

[32] While Professor Fox and I agree that securities class actions need to be justified on this basis, most deterrence comes from parallel claims against controlling shareholders and gatekeepers (such as auditors and investment bankers). To be sure, corporate officers do not wish to be sued, and so even open market, class actions based on stock drops generate some general deterrence. But from either a general tort law perspective, it makes better sense to focus on who is the best cost avoider and impose liability on that

person. The obvious answer is that the senior management and/or the controlling persons of the issuer, or the company's gatekeepers, can do more to minimize the costs associated with materially misleading disclosures than can dispersed shareholders.

Lest it be thought that I am viewing all litigation issues exclusively from the defendants' perspective, see John C. Coffee Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, 84 Boston Univ. L. Rev. 301 (2004) (proposing stricter liability standards for gatekeepers). Litigation against gatekeepers and controlling persons, or against the corporation itself in the primary market context, makes far more sense than litigation against a public corporation with dispersed ownership in the secondary market context.

[33] Fox, supra note 5, at [35-36]

[34] 501 U.S. 350 (1991).

[35] Id. at 359.

[36] 15 U.S.C. § 78r(a). It is arguable, I concede, that the phrase "affected by such statement" could only require that there be some price inflation and not that there be any subsequent price decline.

[37] Section 18 does not seem to expressly contemplate liability for an omission (although statements made could be misleading because of omissions).

[38] 485 U.S. 224 (1988).

[39] Id. at 245.

[40] I do not mean to endorse this argument, but only to point to the conclusion to which a "plain meaning" approach may lead.

[41] See 15 U.S.C. § 78i(e).

[42] Id.

[43] Because such a holder can still sell the stock at the inflated price, it is linguistically difficult to see how this plaintiff has "sustained" any injury. Such a plaintiff is rather only exposed to potential future injury.

[44] 15 U.S.C. § 78u-4(b)(4).

[45] Restatement (Second) of Torts (1977) § 548A, comment b.

[46] It might be argued that Section 548A is addressing only the primary market context where the defendant sells the stock to the plaintiff. But, a fortiori, the standard should be even stricter in the secondary market context where the judgment falls on generally non-culpable shareholders.

[47] Id.

[48] Section 12(b) of the Securities Act of 1933, 15 U.S.C. § 77(l)(b).

[49] Section 11(e) of the Securities Act of 1933 allows the defendant to establish an affirmative defense by proving that claimed damages represent "other than the depreciation in value of such security resulting from the misstatement or omission in the registration statement …." See 15 U.S.C. § 77k(e). Section 12(b), which was added in 1995, was modeled on Section 11(e) and also requires the defendant to disprove loss causation. See 11 U.S.C. § 77(l)(b). Both provisions refer to "depreciation in value", thus indicating that there must be a post-purchase decline in price. In contrast, Section 21D(b)(4) places the burden of proof on the plaintiff, reflecting in part the fact that it is suing a non-trading issuer.

[50] This point is made in the Government's amicus brief. See Brief for the United States at 25.

[51] See 15 U.S.C. § 78u-4(e).

[52] For Broudo's facts, see supra note 11.

[53] If defendants were to issue a press release summarizing plaintiff's charges when plaintiff filed the class action, this step might serve to trigger the express language of this section.

[54] See text supra at notes 38 to 40. I do not expect that Broudo will be used as the vehicle for such a reconsideration, but pregnant hints could be dropped.

[55] See Brief for United States at 15.

[56] Id. at 19. At this point, we are back to allowing the factfinder to make a speculative judgment uncorroborated by any objective market evidence.

[57] Id. (emphasis in original). This could happen, it adds, if the company simultaneously "corrected the false information and at the same time issued unrelated positive information." Id. at 20. In truth, there seem to be some internal inconsistencies or at least tensions in the Solicitor General's position. At page 15 of the Brief for the United States, the Solicitor General argues that the original price inflation must be "eliminated or reduced," but at pages 19 to 20, the brief seemingly backs off this position and claims that simultaneous price movements in opposite directions are sufficient to show loss causation. See Brief for the United States

at 15 and 19-21. This invites very speculative decision-making by the factfinder. One suspects that the SEC resisted any stronger position on loss causation.

[58] In thinner markets, rescissionary remedies may be appropriate, and that topic is not addressed in this brief comment. I recognize that the issue of damages is distinct from the issue of loss causation, but both Sections 11 and 12b limit damages to “depreciation in value,” and there is little reason to extend Rule 10b-5 further in this context. Finally, in requiring a stock market decline, I do not mean to limit that decline to only those in response to a corrective statement by the corporation. The market may learn in other ways: Barron’s may publish an expose on the corporation’s accounting; short sellers may organize a bear raid on its stock – all these ways should count.