No. 03-932

IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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RESPONDENTS' BRIEF

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QUESTION PRESENTED

Whether to plead loss causation in a Section 10(b) open-market fraud case plaintiffs must do more than plead facts establishing fraud-based inflation and overpayment on the date of their purchase.

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STATEMENT OF THE CASE

This is a securities class action filed on behalf of investors who purchased Dura Pharmaceuticals securities between April 15, 1997, and February 24, 1998 (the "Class Period").[1] Petitioners before this Court, and defendants below, are Dura and several of its top officers (collectively "Dura"). JA60a-63a (¶¶48-50). Respondents, plaintiffs below, allege that Dura made misleading statements to securities analysts and investors on two subjects: (1) sales of Dura's "Ceclor CD" antibiotic product, and (2) the status of its new "Albuterol Spiros" ("AlSpiros") device for delivering Albuterol asthma medicine. JA34a-58a (¶¶1-39). Defendants' misstatements, the plaintiff investors contend, inflated the price of Dura securities through the Class Period (and after), causing them to overpay when they purchased those securities. JA55a (¶37), 58a (¶39), 139a (¶179).

The operative complaint pleads with particularity how Dura falsely represented that Ceclor CD antibiotic sales were increasing—when in truth, Dura knew they were dropping. JA48a-52a (¶¶26-34). Specifically, Ceclor CD sales began to drop around March and April 1997 (from 47,288 units in March to 39,808 in May), falling nearly 50% by midsummer (to 24,797 units in July). JA70a-71a (¶63). Dura nonetheless publicly asserted Ceclor CD sales were strong, falsely reporting increased market share by comparing Ceclor CD, not to the entire class of respiratory antibiotics, but to generic Ceclor products. JA49a (¶28). By late 1997, Dura's sales channels were jammed with many months of unsold inventory, versus the normal one-month supply. JA50a (¶30), 110a (¶135). In December of 1997 Dura began to offer a 5% price reduction to wholesalers, trying to get them to take still more.

[1] JA34a, *et seq.*; *see* JA59a-60a (¶¶41-47) (lead plaintiffs' individual purchases), JA138a-139a (¶¶172-177) (class allegations). The Joint Appendix is cited herein as "JA," and the Certiorari Petition's Appendix is cited as "PA."

JA49a-50a (¶29). Not until early 1998 did Dura belatedly admit to the drop-off in Ceclor CD sales, the clogged sales channels, and the need to hire hundreds of additional sales personnel to move the product and salvage sales. JA51a (¶32), 109a-110a (¶¶134-135).

Dura also falsely represented that completed tests showed its new AlSpiros drug-delivery system, designed to aerosolize a powdered form of the asthma drug Albuterol so that it could be inhaled easily, was effective and poised for Food & Drug Administration ("FDA") approval. JA35a(¶2), 76a-78a (¶¶72-76). In truth, clinical trials and in-house testing had shown that the device was fatally flawed—it never worked properly. JA37a-43a (¶¶7-17), 45a-47a (¶¶22-24), 51a-53a (¶¶33, 35). Dura's top engineers recommended that Dura not proceed with scheduled Phase III clinical trials, let alone file a New Drug Application ("NDA") with the FDA, until the known reliability and stability problems were resolved. JA37a-38a (¶8), 40a (¶11). But Dura's top executives ignored their warnings.[2] During its clinical trials AlSpiros experienced a failure rate exceeding 30%, versus an industry target of less than 1%. JA40a-41a (¶¶11-12), 73a (¶68).

Dura nonetheless told the investing public that it was successfully executing on its AlSpiros drug-delivery technology, and was pleased with the results. *E.g.*, JA45a (¶21), 66a-67a (¶56). This was utterly false. JA72a-74a (¶¶66-70). Even following the disastrous Phase III clinical trials—in which the product had to be modified several times—Dura never

[2] JA40a (¶11), 74a (¶70). In October 1996, Dura's Vice President of Product Development, Robert Eisele, authored an internal report (the "Eisele List") examining and explaining the existing problems with the AlSpiros product. AlSpiros, the report noted, was incapable of consistently delivering the required drug dosage or of withstanding normal use conditions, and its cassette system suffered from instability. JA37a-39a (¶¶8-9). These problems persisted throughout the Phase III final clinical trials despite several modifications. JA39a-43a (¶¶10-17).

managed to solve its stability problems and eventually had to abandon AlSpiros. JA41a-43a (¶¶14-17), 53a (¶35).

Why the misrepresentations? Dura's original business strategy had been to sell niche-market pharmaceutical drugs. JA34a-35a (¶1). By 1995, seeing that it would be increasingly difficult to sustain revenue and earnings-per-share ("EPS") growth solely by securing rights to market niche drugs, management decided to change course. *Id*. Dura would become a *medical-device* company, developing and marketing its own proprietary products. *Id*. Because this metamorphosis would cost millions of dollars—and to avoid a huge negative impact on its reported earnings—Dura's management created Spiros Development Corp. (or "Spiros I") in December 1995, to incur Dura's costs of developing the Spiros drug-delivery system. JA36a (¶¶4-5), JA44a (¶¶18, 20).

By the spring of 1997 the securities market clearly understood that AlSpiros was critical to Dura's future. JA76a-78a (¶¶73-76). Without AlSpiros, said securities analysts, Dura would be "strictly" a specialty-drug marketing company, limited to selling "niche respiratory product lines." JA76a-77a (¶73). AlSpiros was what "differentiates Dura," because it would "provide an important growth catalyst" and add an anticipated $58 million to Dura's sales in 1999, then $100 million in 2000. JA76a-77a (¶73), 78a (¶76).

So, starting in April 1997 through December 1997, defendants began to crow about Ceclor CD sales and AlSpiros—falsely stating that Ceclor CD sales were strong and gaining market share, and that AlSpiros was a "durable" product that "can deliver a consistent dose," *i.e.*, that it worked and was efficacious. JA65a-67a (¶¶55-56). As a consequence, Dura's stock rose from $27-7/8 in April to $44-7/8 by mid-July 1997. JA45a (¶21), 67a (¶57), 81a (¶84). Taking advantage of the inflated price, Dura on July 25, 1997, accomplished a $287.5 million convertible-note offering—its largest securities offering ever. JA92a (¶102). Two lead plaintiffs purchased 65 of those notes, at over $1,000 apiece. JA60a (¶¶45-46). Dura insiders unloaded nearly 190,000 of their own common-stock shares for $7 million in proceeds. JA120a-122a (¶154).

Throughout the fall of 1997, Dura continued to issue positive statements about Ceclor CD sales, and bragged that AlSpiros development was on track for commercial sales beginning in 1998. JA92a-96a (¶¶103-112), 101a-103a (¶¶122-123). As a consequence, Dura's stock price climbed still further, to $52-1/4 on October 8, 1997—an all-time high. JA94a (¶107). Two days later, Dura announced it was going to exercise its option to buy Spiros I's stock using Dura stock, and would launch a successor company—"Spiros II"—via a sale of units to the public that would include warrants to buy the high-flying Dura stock. *Id*. Within a few days, on October 14, 1997, Dura reported record earnings attributing ostensibly strong pharmaceutical-sales growth to several factors, including excellent Ceclor CD sales. JA95a-96a (¶111).

With Dura's stock price high, individual defendants again sold personal stock holdings, collecting another $9.2 million.[3] And on December 17, 1997, Dura and Spiros II successfully completed the Spiros II offering, selling 5.5 million Spiros II units (at $16 each) for $88 million. JA103a (¶124).

On February 24, 1998, within weeks of the offering and insiders sales, Dura shocked investors by admitting that Ceclor CD sales were far weaker than previously represented, and that trying to boost sales would require expanding its sales force by 66%, at great expense. JA51a (¶32), 109a-110a (¶134).

[3] JA105a (¶127), 120a-122a (¶154). Defendant, and former FDA employee, Prettyman, head of Dura's Regulatory Affairs Department, argued against submitting the AlSpiros NDA to the FDA, but when overruled he sold 15,000 shares at $48-1/2 for over $728,000 on November 5—just five days before his department filed the NDA. JA103a (¶123), 105a (¶127).

Dura's stock price dropped 47% in a day, from a high of $39-1/8 on February 24 to a low of $20-3/4 on February 25, on an unprecedented 32-million-share trading volume. JA51a (¶32). The stock tumbled another 40% in the ensuing months as Dura's business performed miserably, with poor earnings and lower-than-expected sales. *See* JA52a-53a (¶34), 110a (¶135), 54a (¶36) (stock chart); "Dura Warns on Profit, Teams Up With Lilly on Insulin," *Bloomberg News*, Sept. 23, 1998 (described in Respondents' November 17, 2004, letter).

In early November 1998, in a press release that misleadingly downplayed the ruling's significance, Dura revealed that the FDA had rejected its AlSpiros NDA. JA110a-111a (¶136). Dura's stock dropped another 20%. *See* JA156a.

When the FDA issued a notice of violation to Dura three days later, charging that the company's press release itself had "'*misleadingly minimize[d] the fact that Dura must conduct a completely new clinical data [study]*,'" Dura quietly removed the misleading press release from its website. JA111a (¶136); *see* November 6, 1998, FDA warning letter to Dura. (described in Respondents' November 17, 2004, letter).

Notably, the FDA denied Dura's application for the very reasons that an internal Dura document (the Eisele List) had catalogued *before* the Class Period in October 1996, showing that the device was neither reliable nor stable. JA110a-111a (¶136). These were the very reasons that made Dura's engineers advise management not to proceed. JA37a-39a (¶¶8-9), 40a (¶11), 74a (¶70). The defects were so severe that Dura ultimately abandoned its attempts to develop the AlSpiros system—it was never proved to be reliable or efficacious. JA53a (¶35), 111a (¶136).[4]

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[4] While Dura's stock price rebounded with the entire pharmaceutical sector in the weeks following the AlSpiros disclosure, it never recovered to half of its Class Period highs exceeding $50. *See* comparison chart that

Investors who had purchased Dura securities at inflated prices filed suit on January 27, 1999, alleging securities fraud and proposing a Class Period that closed with Dura's first negative revelation centering on Ceclor CD. Following amendments the district court dismissed plaintiffs' Second Consolidated Amended Complaint ("SAC") with prejudice and entered judgment, holding that plaintiffs had not pleaded facts raising a strong inference of scienter regarding false statements about Ceclor CD. PA45a-47a. The court further held that because Dura had not mentioned the AlSpiros device in the press release about poor Ceclor CD sales, on which Dura stock dropped 47% at the Class Period's close, plaintiffs had not sufficiently pleaded that false statements about AlSpiros had caused them any loss. PA34a-40a.[5]

Plaintiffs appealed, arguing that the district court had erred in ruling that they could neither plead scienter as to statements about Ceclor CD sales, nor loss causation as to the false AlSpiros statements.

The Ninth Circuit reversed. PA1a-17a. As to Ceclor CD, the Ninth Circuit found that the district court had erred in considering the allegations separately rather than as a whole and directed the district court to consider allegations about

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is described in Respondents' November 17 letter. To be sure, the rebound cut potential damages at the end of an extended Class Period but certainly not by much, as the mean trading price for the 90-day statutory look-back was $12.96. *See* JA154a-156a; *see* stock-price chart compiled from the Complaint's allegations, appended to the end of this brief.

[5] The failure of Dura's sales force, due to a lack of necessary sales agents to execute on Ceclor CD sales, however, necessarily meant the same for AlSpiros—for the two were inextricably linked. JA48a (¶26). The continuing cost of upgrading Dura's sales force, the market would have understood, applied to all of Dura's products. *See*, *e.g.*, "Dura Shares Plunge on Profit Warning, Slow Drug Sales," *Bloomberg News*, Feb. 25, 1998 ("higher sales costs" to affect profits as "Dura will boost its sales force to 450 from 270 this year as it prepares to start sales of its Spiros inhaler in 1999").

Ceclor CD's market share, strength of sales, channel stuffing, and insider sales—as well as any additional allegations from confidential witnesses about manipulating analysts and one defendant's oft-stated phrase "let' em catch us"—in conjunction with one another in evaluating whether plaintiffs had pleaded facts raising a strong inference of scienter. PA14a-15a. As to AlSpiros, the Ninth Circuit followed decades of precedent to hold that loss causation does not in every case require "a disclosure and subsequent drop in the market price of the stock . . . because the injury occurs at the time of the transaction." PA9a. "It is at this time that damages are to be measured." *Id*. Finally, the Ninth Circuit could find no reason to limit amendment on remand to the Ceclor CD allegations. PA15a-16a & n.6.

SUMMARY OF THE ARGUMENT

Dura challenges Ninth Circuit precedent holding that "'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.'" PA9a (quoting *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (Wallace, J., for the court)). Under Ninth Circuit law, "for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock actually occurred, because the injury occurs at the time of the transaction." *Id.* Dura asserts this long-standing rule of law is wrong, and that investors who paid too much for an inflated security must connect a later stock drop to a curative disclosure in order to plead loss causation—no matter the initial overpayment.

Dura's position conflicts not only with established Ninth Circuit precedent, but also with the Private Securities Litigation Reform Act of 1995 ("PSLRA"), this Court's opinions on causation, and common-law proximate-cause principles. All have long identified the loss most proximately and directly caused by fraud as the difference between price and value on the date of purchase—not some later decline in price.

Applying the common-law fraud rule, this Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972), determined that in §10(b) cases the proper measure of recovery is the difference between the transaction price and the value—also known as "out-of-pocket" loss. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1998), this Court reiterated that the relevant causal link in cases of open-market fraud and price manipulation is that between defendants' misrepresentation and resulting transaction price. *See id*. at 243, 248.

Consistent with this Court's decisions, when Congress amended the 1934 Act in 1995 to codify standards for the §10(b) cause of action, it provided that investors who manage to plead evidentiary facts both demonstrating false statements and raising a strong inference of fraudulent intent—with the particularity required to survive heightened pleading standards on a motion to dismiss—then "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." 15 U.S.C. §78u-4(b)(4). "For example," the legislation's Conference Report and Senate Report both explain, "*the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission*." H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740 (emphasis added); S. Rep. No. 104-98, at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694. Thus, under the PSLRA, investors prove a recoverable loss by showing that a defendant's scienter-laden false statement inflated the price they paid. *See id*.

This standard—which effectively codifies the traditional rule that the loss proximately caused by fraud affecting an investment decision amounts to the difference between price and value at the time of the transaction—produces no "windfalls" or "double recoveries." Just the opposite. "If the stock is resold at an inflated price, the purchaser-seller's damages, limited by §28(a) of the Act, 15 U.S.C. §78bb(a), to 'actual damages,' must be diminished by the inflation he recovers from his purchaser." *Blackie v. Barrack*, 524 F.2d 891, 908-09 (9th Cir. 1975); *see Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 & n.4 (9th Cir. 1987); *Green v. Occidental Petroleum*, 541 F.2d 1335, 1345-46 (9th Cir. 1976) (Sneed, J. concurring). The rule has served well for decades.

From a practical standpoint, the rule now urged by Dura—requiring a corrective disclosure linked to a stock-price drop—would be disastrous both for investors and the integrity of our securities markets. Under the PSLRA defrauded investors must already plead with particularity facts demonstrating a material misrepresentation or omission, which caused the stock to be inflated when purchased. *See* 15 U.S.C. §78u-4(b)(1). They must also set forth specific facts raising not merely a reasonable inference, but a *strong inference*, of scienter. *See* 15 U.S.C. §78u-4(b)(2). Were investors required to also plead subsequent disclosures of the fraud by confession or otherwise, linking these disclosures to a drop in the price of the stock, the additional hurdles could often be insurmountable. The reasons are not complex.

Market valuations are based upon expected future cash flows discounted by the cost of capital, commonly referred to as discounted cash flows.[6] Open-market frauds manipulate

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[6] *See* Burton G. Malkiel, *Is The Stock Market Efficient?*, 243 Science 1313, 1316 (Mar. 10, 1989); Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. Bus. 411, 415-16 (1961); Richard A. Brealey & Stewart C. Myers, *Capital Investment and Valuation* 77 (2003); R.A. Brealey, *An Introduction to Risk and Return From Common Stock* 67-72, 78 n.1 (2d ed. 1983); Eugene F. Fama & Merton H. Miller, *The Theory of Finance* 87-89 (1972); *see also* Jay W. Eisenhofer, Geoffrey C. Jarvis & James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a*

stock-market prices by artificially raising cash-flow expectations. Sophisticated individuals who would commit market manipulation and fraud are likely to be adept at concealing it. Expectations can be lowered, thereby reducing fraud-induced inflation without disclosure of the fraud, by further false statements.[7] Even the passage of time itself will dissipate a fraud's impact on a stock's price.[8] On Dura's theory, simply concealing the fraud would reduce the recoverable loss—not the loss actually suffered. And once expectations are lowered, even if the full extent of the fraud is then revealed, its disclosure's impact on a stock's price could be negligible.

Congress recently extended the statue of repose for §10(b) actions from three to five years with the passage of the Sarbanes-Oxley Act in 2002 in order to enable private investors more time to uncover and pursue securities fraud. *See* Pub. L. No. 107-204, §804(a), 116 Stat. 801 (July 30, 2002), adding 28 U.S.C. §1658(b)(2). Co-sponsor Senator McCain explained that "the worst offenders may avoid accountability and be rewarded if they can successfully cover up their misconduct for merely three years. The more complex the case, the easier it will be for these wrongdoers to get away

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Corporate Finance-Based Theory of Loss Causation, 59 Bus. Law. 1419, 1421-24 (2004).

[7] *See* Eisenhofer, *supra*, 59 Bus. Law. at 1443.

[8] Inflation due to an earnings misstatement ages over time, as does inflation from sales or asset overstatements. *See* Marcia Kramer Mayer, Ph.D., *Loss Causation and Damages: Dura and Beyond*, NERA Economic Consulting (Sept. 30, 2004) ("NERA Presentation," described in Respondents' November 17 letter); *see also In re Initial Pub. Offering Sec. Litig*., 297 F. Supp. 2d 668, 673 (S.D.N.Y. 2003) ("*IPO*") ("ordinary market forces affect the rate of artificial inflation" because in some circumstances "the normal functioning of the securities market causes the inflationary effect to dissipate over time"); A.A. Berle, *Liability For Stock Market Manipulation*, 31 Colum. L. Rev. 264, 269 (1931) ("a false statement . . . some years ago would have little appreciable effect on the price of the stock today").

with fraud." 148 Cong. Rec. S6528-29 (July 10, 2002).[9] The ability to conceal and the passage of time should not relieve those who commit securities fraud because the inflationary effects of their fraud have dissipated during the five years that Congress has now given investors to uncover and pursue. *See* 28 U.S.C. §1658(b)(2).

In addition, a complex scheme's impact on a company's stock price necessitates expert analysis to eliminate market variables and isolate company-specific information, which may require an event study with regression analysis, and even discovery, for a full understanding of the scheme, its scope, and duration.[10] With the PSLRA's automatic stay of discovery until *after* a determination on the pleadings, *see* 15 U.S.C. §78u-4(b)(3)(B), such a full analysis may simply be impossible to perform at the pleading stage. It is better left for proof, per the statute, at summary judgment or trial.

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[9] In cases such as *Enron*, *Worldcom*, *Qwest*, *Healthsouth*, and other recent disasters, where Respondents' counsel's clients include some of the largest public and private funds in the world such as the California Public Employees' Retirement System, Central States, Southeast, and Southwest Areas Pension Fund (Teamsters), Northwestern Mutual, The Regents of the University of California, Western Conference of Teamsters Pension Trust Fund, as well as the state retirement funds of Alaska, Idaho, Maine, New Hampshire, New Mexico, Ohio, Tennessee, Washington and West Virginia, the full extent of the fraud or each participant's role (including the accountants, bankers, and lawyers) was not revealed until long after these stocks collapsed. Were the rules urged by Dura and its *amici* adopted, any meaningful recovery to the beneficiaries of these funds could be effectively denied.

[10] On the necessity of expert analysis and event studies in calculating inflation resulting from fraud while excluding other market variables, *see* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 17-19 (1982); Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud in the Market Cases*, 37 U.C.L.A. L. Rev. 883, 897-911 (1990); Eisenhofer, *supra*, 59 Bus. Law. at 1424-28, 1444-45.

The present case illustrates the problems that may be encountered. On the disclosure of poor Ceclor CD sales the stock price dropped 47%, but this disclosure—aside from being months late and after significant insider sales—included no disclosure about Dura's AlSpiros reliability problems, which had been fully documented within Dura the year before.[11] The stock tumbled another 40% in the ensuing months as Dura's business continued to deteriorate. By the time of the belated November 1998 AlSpiros announcement, Dura's stock had already been crushed—but it still dropped another 20% on the news. *Even then* defendants continued to mislead the investing public by minimizing the device's failure, causing the FDA to issue a notice of violation. Dura quietly removed the press release from its website, but it did not disclose the truth. Ultimately, the product's problems were insurmountable, causing the company to abandon its further development.

ARGUMENT

I. PRE-PSLRA SUPREME COURT AND CIRCUIT DECISIONS ESTABLISHED LOSS CAUSATION PRINCIPLES FOR §10(b) CASES: THE INVESTOR'S LOSS IS PAYING A FRAUD-INFLATED PURCHASE PRICE

Dura, and the United States as *amicus curiae*, say that "when Congress passed the PSLRA, loss causation was generally recognized as a judicially inferred element of a Rule 10b-5 cause of action. The PSLRA codified the loss-causation requirement, making it a statutory element." U.S. Brief at 10. Yet, the loss-causation precedents that Dura and its *amici* say Congress codified—such as *Robbins v. Koger Props.*, 116 F.3d 1441, 1448 (11th Cir. 1997), *Semerenko v.*

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[11] The disclosure did, however, have an impact on the costs of sales associated with the expected AlSpiros release, as picked up by the market. *See* n.5, *supra*.

Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) (dictum), and *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group*, 343 F.3d 189, 198 (2d Cir. 2003) (dictum)—actually post-date the 1995 legislation.

While it is wholly proper "to look to 'the state of the law at the time the legislation was enacted,'" *Randall v. Loftsgaarden*, 478 U.S. 647, 663 (1986) (citation omitted), Congress in 1995 could not possibly have intended to codify these *later* decisions' gloss on loss causation. What Congress knew and codified were earlier holdings—that the recoverable loss proximately caused by fraud is the difference between price and value on the date of purchase, not some later decline in price. That was the common-law rule, codified in §9(e) of the 1934 Act, 15 U.S.C. §78i(e), adopted for §10(b) actions, and applied by this Court in its major securities-fraud precedents. It is the law under §21D(b)(4). *See Midlantic Nat'l Bank v. New Jersey. Dep't of Envtl. Prot.*, 474 U.S. 494, 501 (1986) ("The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific.").

A. Under the Common Law of Deceit and Market Manipulation an Investor's Loss Is the Difference Between the Fraud-Inflated Price Paid and Value on the Date of the Transaction

Rule 10b-5 is "distinct from common-law deceit and misrepresentations" because it was "in part designed to add to the protections provided investors by the common law." *Basic*, 485 U.S. at 244 n.22. Nonetheless, as the United States observes, courts properly look to common-law doctrines "in deciding what elements a Rule 10b-5 cause of action comprises, and what must be pleaded and proved to establish them." U.S. Brief at 10. "That is certainly true of loss causation." *Id*. at 10-11. "As Judge Posner has observed, 'what securities lawyers call "loss causation" *is* the standard common law fraud rule ***, merely borrowed for use in federal securities fraud cases.'" *Id*. at 11 (quoting *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 683 (7th Cir. 1990) (Posner, J., for the court)); *accord*, *e.g.*, *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997) (§10(b) "loss causation" is "nothing more than the 'standard common law fraud rule'").

The common-law rule was well-established preceding passage of the Securities Exchange Act of 1934. This Court held in *Sigafus v. Porter*, 179 U.S. 116, 122-26 (1900), that when one induced by misstatements (or omissions) to make an investment overpays, the core loss proximately caused by the fraud is suffered at the time of the initial purchase—by paying more than the investment was then worth. It is "'the difference between the real value of the stock at the time of sale and the fictitious value at which the buyer was induced to purchase.'" *Id*. at 124 (quoting *High v. Berret*, 148 Pa. 261, 264, 23 A. 1004 (1892)). This is the common-law fraud rule: "In an action based upon fraud the purchaser is entitled to recover his actual loss measured by the difference between the price he paid and the value of that which he received, determined as of the time of the transaction." *Kaufman v. Mellon Nat'l Bank & Tr. Co.*, 366 F.2d 326, 331 (3d Cir. 1966).

Section 10(b)'s other parent, the common law of market manipulation, similarly saw investors' loss in the payment of an inflated price. Holding in *McMullen v. Hoffman*, 174 U.S. 639 (1899), that an anticompetitive bid-rigging contract is against public policy, this Court observed that *Rex v. De Berenger*, 3 M. & S. 67, 72, 105 Eng. Rep. 536 (1814), had addressed a plot "'by false rumors to raise the price of the public funds and securities.'" *McMullen*, 174 U.S. at 649 (quoting *De Berenger*, 3 M. & S. at 72-73 (cited in *Scott v. Brown*, 2 Q.B.D. 724, 730 (1892))). Such conduct, it said, "'strikes at the price of a vendible commodity in the market, and if it gives it a fictitious price by means of false rumors, it is a fraud leveled against all the public, for it is against all such as may possibly have anything to do with the funds on that particular day.'" *Id.* The injury to public investors was in paying a fictitious or fraudulent price.[12]

The rule is a very conservative one, denying defrauded investors the right to recover the expected benefit of their bargain. *See Sigafus,* 179 U.S. at 123; *Smith v. Bolles,* 132 U.S. 125, 129-30 (1889). And while victims of other types of fraud generally may recover not only the difference between price paid and value received, but also further consequential damages,[13] investment-fraud victims ordinarily are limited to only the out-of-pocket loss measured at the time of their investment. "In the federal courts the measure of damages recoverable by one who through fraud or misrepresentation has been induced to purchase bonds or corporate stock, is *the difference between the contract price, or the price paid, and the real or actual value at the date of the sale*, together with such outlays as are attributable to the defendant's conduct." *Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962) (citing precedents; emphasis added); *see* Arthur L. Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 Tex. L. Rev. 469, 471-79 (1988).

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[12] "'The means used are wrong, they are false rumors; the object is wrong, it was to give a false value to a commodity in the public market, which was injurious to those who had to purchase.'" *De Berenger*, 3 M. & S. at 76-77, 105 Eng. Rep. at 540 (Dampier, J.) (quoted in *United States v. Brown*, 5 F. Supp. 81, 86 (S.D.N.Y. 1933), *aff'd*, 79 F. 321 (2d Cir. 1935)). *See also* Berle, *supra*, 31 Colum. L. Rev. at 268-70.

[13] *See Restatement (Second) of Torts* §549 (1977); *Restatement of Torts* §549 (1938); W. Page Keeton, et al., *Prosser and Keeton on the Law of Torts* §110, at 766 (5th ed. 1984).

B. The Securities Exchange Act of 1934 Codified the Common-Law Rule that an Investor's Injury Consists of Paying a Fictitious Price

Congress codified the inflated-price rule in the 1934 Act's express remedies that "target the precise dangers that are the focus of §10(b)." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360-61 (1991). Like §10(b), they are "designed to protect investors against manipulation of securities prices." *Basic,* 485 U.S. at 230 (citing S. Rep. No. 73-792, at 1-5 (1934)); *see* 15 U.S.C. §§78i(e), 78r(a).

As this Court observed in *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 46 (1977), for example, "§9 provides an express cause of action for persons injured by unlawful market activities," and "is framed specifically in favor of 'any person who shall purchase or sell any security *at a price which was affected by such act or transaction*. . . .'" *Id.* (Court's emphasis).[14] "Congress therefore focused in §9 upon the amount actually paid by an investor for stock that had been the subject of manipulative activity."[15] The recoverable loss, then, is the "improper premium" at which the stock traded, over the price at which it would have traded absent the manipulative misconduct.[16]

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[14] Section 9 covers certain misleading statements, in addition to misleading transactions called "wash sales" and "matched orders." *See* 15 U.S.C. §78i(a)(4).

[15] 403 U.S. at 46. The 1934 Act's legislative history confirms: "In order to render effective the prohibitions against manipulation, violators are not only subject to the penalties prescribed in the act, but are liable in damages to any person who purchases or sells a security at a price which was effected [*sic*] by the violation." S. Rep. No. 73-1455, at 55 (1934).

[16] 403 U.S. at 46; *see generally* Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 Ind. L. Rev. 357, 367-68 (1991); *see also Rosenberg v. Hano*, 121 F.2d 818, 821 (3d Cir. 1941) (to recover under §9(e) an investor "must either have entered a false market or paid a false price to enter a genuine market").

When investors purchase securities at a fictitious and fraudulent price, their loss under §10(b) must be, as it is under the 1934 Act's express remedies, the "improper premium" paid. *See Piper*, 403 U.S. at 46. This Court has long held that §9 and §10(b), in particular, are fraternal twins—looking to §9 to inform its interpretation of §10(b), *see, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977), and even adopting §9(e)'s express provisions to govern implied actions under §10(b). *See, e.g., Lampf*, 501 U.S. at 364 n.9 ("we select as the governing standard for an action under §10(b) the language of §9(e) of the 1934 Act"). Congress's determination of what loss investors should recover when deceptive conduct affects the price at which securities trade is both instructive, and clear. Fraud causes loss when investors pay an inflated price.[17]

C. Section 10(b) Precedents Embrace the Traditional Rule that Loss Is Suffered at the Time of Purchase

This Court applied the fraud-inflated-price rule to §10(b) claims in *Affiliated Ute*, 406 U.S. at 155, after lower courts had widely adopted it for the Rule 10b-5 cause of action. *See* 9 Louis Loss & Joel Seligman, *Securities Regulation* 4412-4415 & nn.484, 485 (3d ed. 2004); *see also, e.g., Estate Counseling*, 303 F.2d at 533; *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965).

In *Affiliated Ute*, a bank's transfer agents violated Rule 10b-5 by purchasing securities from mixed-blood Indians

[17] Congress also provided in 1934 Act §18(a) that those who cause misleading statements to be filed with the SEC are liable to all "who, in reliance upon such statement, shall have purchased or sold a security *at a price which was affected by such statement*, for damages caused by such reliance." 15 U.S.C. §78r(a) (emphasis added). Again, the focus is on the injury suffered in paying "a price which was affected" by the misleading statement. *Id.*; *see* Kaufman, *Loss Causation*, 24 Ind. L. Rev. at 368-69.

without disclosing the rather material fact that the securities could be sold for substantially more on an active non-Indian market. In §10(b) cases involving primarily a breached duty to disclose, this Court held, *materiality* of the omitted information establishes the "requisite element of causation in fact," permitting the plaintiffs to recover "the difference" between the transaction price and what the securities otherwise were worth. 406 U.S. at 154-55 ("the difference between the fair value of all the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct"). The recoverable loss was both suffered—and measured—at the time of the transaction.[18]

Nothing in *Affiliated Ute* suggests that to prove causation under §10(b), plaintiffs must establish that the defendant's conduct also caused a *post-transaction* change in the price of the security. Rather, when investors show how a defendant's fraudulent conduct created a disparity between the transaction price and the securities' value measured *at the time of the transaction*, they establish that the defendant's conduct caused their losses. *Affiliated Ute*, 406 U.S. at 155. As this Court later explained:

> In *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972), which involved violations of §10(b) and Rule 10b-5 by a buyer of securities, this Court held in a §10(b) action that "the correct measure of damages under §28 . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct."

[18] *Id*.; *see* Michael J. Kaufman, *Securities Litigation: Damages* §11-18 to §11-19 (2003); Kaufman, *Loss Causation*, 24 Ind. L. Rev. at 387.

Randall, 478 U.S. at 661-62; *see id*. at 662 ("Courts have also generally applied this 'out-of-pocket' measure of damages in §10(b) cases involving fraud by a seller of securities.").[19]

Following *Affiliated Ute*, the Ninth Circuit held in *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), that

> causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation of the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a *prima facie* case.

Blackie, 524 F.2d at 906.

Liability is predicated "on a showing of economic damage (loss causation)," suffered upon purchase, with investors' individual "transactional causation" or reliance inferred secondarily from the fact that reasonable investors would not choose to incur the loss.[20] Thus, the necessary "causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of

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[19] This rule deals with market value, of course, not the medieval scholastics' concept of inherent value. *See* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 Cornell L. Rev. 907, 919-20 (1989); William J. Carney, *The Limits of the Fraud on the Market Doctrine*, 44 Bus. Law. 1259, 1271-73 & n.69 (1989).

[20] *Id*. at 906. Ninth Circuit decisions consistently hold that "in an action brought under Rule 10b-5 for material omissions or misstatements, the plaintiff must prove both transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused harm." *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984).

artificially inflated stock." *Blackie*, 524 F.2d at 908. Defendants, of course, retain the right to disprove causation within the traditional framework limiting recovery to those who "are in fact injured." *Id*. at 906-07 n.22.

In *Blackie*, defendants asserted (as do Dura's *amici*) that the loss must be determined by the change in price after a corrective release. *See Blackie*, 524 F.2d at 909 n.25. The Ninth Circuit held that such a "drop is of course circumstantial evidence of the inflation when purchased, but is not the exclusive method of measuring inflation." *Id*. Other market variables, including the passage of time, or changed conditions and partial disclosures, may affect later market reaction—necessitating expert testimony and the examination of company-specific information to determine the actual inflation on the date of purchase. *See id.* at 906-09 nn.22, 25.

In 1976, in *Green v. Occidental Petroleum Corp.*, Judge Sneed authored a lengthy and influential concurrence explaining the out-of-pocket rule and its application. He noted that under *Blackie*, the traditional "out-of-pocket measure" fixes recovery in investment-fraud cases at the difference between the purchase price and the value of the investment on the date of purchase—rather than at some later date. 541 F.2d. at 1344. "This difference is proximately caused by the misrepresentations of the defendant. It measures precisely the extent to which the purchaser has been required to invest a greater amount than otherwise would have been necessary." *Id*; *see also Knapp*, 90 F.3d at 1438 (Wallace, J., for the court).

Other circuit courts have long applied this "out-of-pocket" rule of loss-causation to claims under Rule 10b-5. They hold that "the issue is the amount by which each class member was defrauded on the date of his purchase. Any subsequent decline in market value had no effect on that fraudulent sale." *Sirota v. Solitron Dev. Inc.*, 673 F.2d 566, 577-78 (2d Cir. 1982) (rejecting a defendant's contentions that the plaintiff investor's recoverable loss must be reduced in light of the drastic market decline of 1970).[21] Judge Posner has explained that the term "loss causation" generally refers, then, to the "loss produced by a discrepancy between the actual market value of a stock and what that value would have been had there been no misrepresentation." *Isquith v. Caremark Int'l*, 136 F.3d 531, 535 (7th Cir. 1998) (Posner, J., for the court).

Dura and its *amici* suggest that this rule makes those who perpetrate frauds "insurers" against unrelated market declines following any investment decisions induced by fraud. But the traditional rule's purpose and effect are precisely the opposite. The traditional view of proximate cause—seeing loss as the difference between price and value at the time of the investment rather than as a subsequent, likely much larger, decline in value of the security—Judge Sneed explained in *Green*, "furthers the purpose of rule 10b-5 without subjecting the wrongdoer to damages" for unforeseeable "natural disasters" or for general market declines unrelated to the fraud. *Green*, 541 F.2d at 1344. The defendant never becomes an

[21] *Accord, e.g.*, *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 214 (7th Cir. 1993) (Easterbrook, J.); *Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp.*, 910 F.2d 1540, 1551 (7th Cir. 1990) (rejecting benefit-of-the-bargain for out-of-pocket loss; citing *Sigafus*); *Mayer v. Mylod*, 988 F.2d 635, 640 (6th Cir. 1993) ("Under Section 10(b), the level of damages is usually the difference in price that the investor paid based on false or misleading statements and the price that the stock would have sold at had the market been aware of the truth."); *Hoxworth v. Blinder, Robinson & Co.*, 903 F.2d 186, 203 n.25 (3d Cir. 1990) ("Ordinarily, a defrauded buyer is entitled to out-of-pocket damages under rule 10b-5."); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1136-37 (5th Cir. 1988), *vacated on other grounds*, 492 U.S. 914 (1989); *Flamm v. Eberstadt*, 814 F.2d 1169, 1179-80 (7th Cir. 1987) (Easterbrook, J.); *Harris v. Union Elec. Co.*, 787 F.2d 355, 367-68 (8th Cir. 1986); *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1360 (8th Cir. 1977) (out-of-pocket rule "provides for the recovery of the difference between the actual value of the securities and their purchase price").

"insurer" against general market risks precisely because, in the typical case, it is liable only for the initial inflation caused by a material misrepresentation or omission—no more, but no less.

And while Dura and its *amici* contend the traditional rule creates a risk of "windfall" or "double" recoveries for investors who sell the stock at a similarly inflated price, that has never been true: "If the stock is resold at an inflated price, the purchaser-seller's damages . . . must be diminished by the inflation he recovers from his purchaser." *Blackie*, 524 F.2d at 908-09; *accord*, *e.g.*, *Green*, 541 F.2d at 1344-46 (Sneed, J., concurring); *Wool*, 818 F.2d at 1437-38 & n.4. "For purchasers who sell *after* a disclosure which completely corrected the misrepresentations of the defendant, damages are determined only at the *time of purchase*." *Wool*, 818 F.2d at 1437 n.4 (court's emphasis). "For in-and-out traders, on the other hand, both the *time of purchase* and the *time of sale* are considered in determining recoverable damages." *Id*. (court's emphasis). The Ninth Circuit explained in *Wool*:

> Instead of determining the damages at the date of purchase, therefore, a two-step process is used when dealing with in-and-out traders. First, the spread between market price and value of the stock at the time of purchase is determined. When the purchaser sells the stock, the spread is again measured.

Id. "If the spread has diminished" the purchaser would recover the difference. *Id*. But not otherwise. In practice, as well as theory, courts disallow the double-recoveries and windfalls that Dura and its *amici* purport to fear. *See*, *e.g.*, *In re Cendant Corp. Sec. Litig.*, 109 F. Supp. 2d 235, 254 (D.N.J. 2000), *aff'd*, 264 F.3d 201 (3d Cir. 2001); *In re LTV Sec. Litig.*, 88 F.R.D. 134, 148-49 (N.D. Tex. 1980).

While Dura suggests that the Fifth Circuit in *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375

(1983), came to a radically different conclusion on recoverable losses in §10(b) cases, that is not so. In *Huddleston*, the Fifth Circuit said that when investors point to a stock's decline in value, claiming it as their loss, "[t]he causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value." *Id.* There is no reason to think that with these words the Fifth Circuit meant to abandon the traditional rule—reaffirmed later in the same opinion—that the investors were entitled to recover "the difference between the price paid and the 'real' value of the security, *i.e.*, the fair market value absent the misrepresentations, at the time of the initial purchase." *Id.* at 554-55. This difference the Fifth Circuit recognized as "the loss proximately caused by the defendants' deceit." *Id.* at 555.[22]

This Court again embraced the traditional rule, and existing law on causation, in *Basic*. '"In an open and developed market, the dissemination of material misrepresentations or withholding of material information typically affects the price of the stock . . . ."' 485 U.S. at 244 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986)). Under such circumstances, this Court agreed with *Blackie*, the required "'causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the

[22] A footnote's illustrative hypothetical earlier in the opinion is perhaps at odds with *Huddleston's* ultimate holding. The hypothetical suggests that misrepresentations about a ship's capacity may not lead to recovery if the ship sinks for reasons unrelated to capacity. Investors' damages, however, "consist of two components: the value lost due to the casualty and the amount lost because [the investor] overpaid for the stock. This latter component of damages is related directly to the initial misrepresentation. Hence, this amount should be recoverable in an action for securities fraud." *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 650 F. Supp. 1346, 1353-54 (W.D. Wash. 1986), *aff'd*, 823 F.2d 1349 (9th Cir. 1987) ("*WPPSS*").

form of artificially inflated stock.'" *Basic*, 485 U.S. at 244-45 (quoting *Blackie*, 524 F.2d at 908).[23]

Discussing how reliance and causation may be rebutted this Court focused, again, not on the post-transaction movements in the value of the security, but on the causal "link between the alleged misrepresentation and either the price received (or paid) by the plaintiff." *Basic*, 485 U.S. at 248. Defendants thus are entitled to "show that the misrepresentation in fact did not lead to a distortion of price." *Id*. If, for example, they "could show that the 'market makers' were privy to the truth . . . and thus that the market price would not have been affected by their misrepresentations, the causal connection could be broken." *Id*. What the price does *after* the loss was suffered never comes into the equation—except as one piece of *evidence* of the amount of inflation. *See Blackie*, 524 F.2d at 909 n.25.

Until the PSLRA's enactment in 1995, the case law remained quite consistent. After *Basic*, the Third Circuit in *Scattergood v. Perelman*, 945 F.2d 618, 624 (3d Cir. 1991), reversed dismissal on the pleadings because "the fair inference from the complaint, if one assumes—as we must—the truth of its allegations, is that the market price paid by the plaintiffs exceeded the value of the stock at the time of the purchase based on the true facts. In other words, the complaint suggests that the price paid exceeded the value that the market would have established for the Andrews stock had the defendants disclosed their scheme . . . ."

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[23] *Cf.* Fischel, *supra*, *Use of Modern Finance Theory*, 38 Bus. Law. at 11 ("Investors would not be willing or have to pay the increment attributable to distortion of the price if the true information were known.").

And in *Pommer v. Medtest Corp.*, 961 F.2d 620, 628 (7th Cir. 1992), Judge Easterbrook contrasted §10(b) with the 1933 Act's provision for rescissory damages, explaining that:

> Damages under §10(b), by contrast, usually are the difference between the price of the stock and its value on the date of the transaction if the full truth were known. Sometimes this principle comes under the name "loss causation": the plaintiff must establish that the misstatement caused him to incur the loss of which he complains; it is not enough to establish that the misrepresentation caused him to buy or sell the securities.

Id. (citation omitted).

Thus, when Congress codified loss causation in 1995, the causation that counted in Rule 10b-5 cases involving open-market purchasers of securities was the nexus between the defendant's conduct and the transaction price. When plaintiffs pleaded that misleading statements and omissions created a difference between that transaction price and the true value of the securities at the time of the transaction, they thereby established, at least at the pleading stage, that the defendant's conduct caused their recoverable losses. The legislation's Senate Report, for example, says that Congress intended to codify "current law" on the point. S. Rep. No. 104-98, at 7; *see infra*.

II. THE PSLRA ADOPTED THE TRADITIONAL FRAUD-INFLATED-PRICE RULE OF LOSS CAUSATION FROM PRE-PSLRA SUPREME COURT AND CIRCUIT COURT DECISIONS

It was in this context that Congress codified "loss causation" as an element of §10(b) liability, in Securities Exchange Act §21D(b)(4). Congress determined that if investors survived the PSLRA's heightened pleading standards on a motion to dismiss, *see* 15 U.S.C. §78u-4(b)(1)-(3), they then "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." 15 U.S.C. §78u-4(b)(4). The statute's plain language imposes pleading requirements for misleading statements and scienter, but it says nothing at all about pleading loss—only that the plaintiff eventually must prove loss. Even then, its text says nothing about linking a specific corrective disclosure to a stock drop. The legislative record, in fact, confirms that in fraud-on-the-market cases the new provision's standard is met with evidence establishing fraudulent inflation of a security's price at the time the plaintiff bought it.

Although Dura says that in 1994 members of the 103d Congress had "expressed concern that some courts were adopting a presumption of loss causation, as well as reliance, in fraud-on-the-market cases" (Petitioners' Brief at 29 n.9), the supporting document—a subcommittee staff report—states only that because other factors may neutralize a misrepresentation's effects, "it may therefore be appropriate to require plaintiffs to provide proof in fraud-on-the-market cases that the alleged misrepresentation caused an effect on market price."[24]

Moving on to the 104th Congress, the House bill to reform securities litigation would have required a plaintiff to prove "that the misstatement or omission proximately caused (through both transaction causation and loss causation) any

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[24] The staff report explained: "There may be cases in which the plaintiff reasonably relied on the integrity of the market price, but the market price was not affected by the defendants' misrepresentations because other information in the market neutralized any impact which the misrepresentation might have had." Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, Staff Report on Private Securities Litigation 58 (May 17, 1994), *reprinted in Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the Subcommittee on Securities*, 103d Cong., 228 (May 12, 1994).

loss incurred by the plaintiff." H.R. 10, 104th Cong., §204 (Jan. 4, 1995).[25] The Senate bill, on the other hand, provided that in fraud-on-the-market cases "the plaintiff shall have the burden of proving that the misstatement or omission caused any loss incurred by the plaintiff." S. 240, 104th Cong., §104 (Jan. 18, 1995).[26]

Its authors' section-by-section analysis explained that the provision "clarifies that in implied actions based on the 'fraud in the market' theory, while the plaintiff need not show that he or she specifically relied on any alleged misstatement or omission, plaintiff has the burden of showing that the misstatement or omission caused the loss." 141 Cong. Rec. S1086-87 (Jan. 18, 1995). "This means that plaintiff must establish that it was the defendant's misstatement or omission, rather than some intervening factor, which established the market price at which the plaintiff purchased or sold the securities in question." *Id.* Plaintiffs, in fraud-on-the-market cases, would have to show that the fraud alleged affected the price that they paid. *See id.*[27]

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[25] With H.R. 10, Congress initially considered dramatically narrowing the fraud-on-the-market doctrine as articulated in *Basic*, but ultimately left the *Basic* decision intact, thereby retaining a strong fraud-on-the-market doctrine as set forth by this Court. *See* H.R. Rep. No. 104-50, at 65-66 (Feb. 24, 1995).

[26] The Senate bill's loss-causation provision read in full:

> (c) BURDEN OF PROOF—In an implied private action under this title based on a material misstatement or omission concerning a security, and in which the plaintiff claims to have bought or sold the security based on a reasonable belief that the market value of the security reflected all publicly available information, *the plaintiff shall have the burden of proving that the misstatement or omission caused any loss incurred by the plaintiff.*

S. 240, 104th Cong., §104 (Jan. 18, 1995) (emphasis added).

[27] Such an explanation, from the drafters themselves, is highly significant. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-03 (1976)

The SEC, in a letter from Chairman Arthur Levitt to Senator Richard Bryan, concurred that "S. 240 would make it clear that the plaintiff is required to prove that the misstatement or omission caused his loss; *i.e.*, that the price at which the plaintiff purchased his shares was artificially inflated as a result of the misstatement or omission."[28] All agreed that loss consisted of paying an inflated price.

The Banking Committee amended the Senate bill by simplifying and broadening its text to apply to all private claims under the 1934 Act, and by adding a second sentence (later dropped in Conference). As reported by the Committee, it provided:

> In any private action arising under this title, the plaintiff shall have the burden of proving that the act or omission alleged to violate this title caused any loss incurred by the plaintiff. Damages arising from such loss may be mitigated upon a showing by the defendant that factors unrelated to such act or omission contributed to the loss.

S. 240, 104th Cong., §104(b) (June 19, 1995). The second sentence restated what the Ninth Circuit held in *Blackie* and this Court in *Basic*—that defendants are entitled to rebut a plaintiff's *prima facie* case by showing there was no inflation. *See Basic*, 485 U.S. at 248-49; *Blackie*, 524 F.2d at 906 & n.22; *see, e.g., In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1114-16 (9th Cir. 1989).

The Senate Report characterized the provision as one "codifying the requirement under current law that plaintiffs

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(holding that a "brief explanation of §10(b) by a spokesman for its drafters is significant"); *Philko Aviation, Inc. v. Shacket*, 462 U.S. 406, 410 (1983) (interpreting statute as "dictated by" the "House and House Conference Committee Reports, and the section-by-section analysis of one of the bill's drafters").

[28] Letter from Arthur Levitt to Senator Richard Bryan, at 8 (May 11, 1995) (described in Respondents' November 17 letter).

prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors," explaining that it

> requires the plaintiff to show that the misstatement or [omission] alleged in the complaint caused the loss incurred by the plaintiff. *For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission*. The defendant would then have the opportunity to prove any mitigating circumstances, or that factors unrelated to the fraud contributed to the loss.

S. Rep. No. 104-98, at 7, 15 (emphasis added). Once again, the relevant loss clearly consisted of paying an artificially inflated price, with the legislation requiring eventual proof merely "that the price at which the plaintiff bought the stock was artificially inflated." *Id*.

In the end, the Conference Committee dropped the second sentence and enacted: "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." 15 U.S.C. §78u-4(b)(4). The only suggestion that §21D(b)(4) might require plaintiffs to *plead* anything about loss causation came not from the new statute's text, but from the accompanying Statement of the Managers which confirmed, once more, that loss is suffered by paying an artificially inflated price:

> *Loss causation*
>
> The Conference Committee also requires the plaintiff *to plead and then to prove* that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff in new Section 21D(b)(4) of the 1934 Act. *For example, the plaintiff would have to prove that the price at which the plaintiff bought the*

> *stock was artificially inflated as the result of the misstatement or omission*.

H.R. Conf. Rep. No. 104-369, at 41 (emphasis added).

This, of course, is what the Ninth Circuit holds—that "plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." *Knapp*, 90 F.3d at 1438 (Wallace, J., for the court); *see* PA9a (quoting *Knapp*). This is the very rule applied in *Basic*, which held that "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury," which may be '"established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock.'" *Basic*, 485 U.S. at 243-45 (quoting *Blackie*, 524 F.2d at 908). Thus, the 1995 legislation codifies the older rule and Ninth Circuit law, rather than the newer "rule" that Dura and its *amici* try to derive from subsequent decisions.

A. Section 21D(b)(4), Which Speaks of "Proof," Not Pleading, Cannot Be Reasonably Construed as Imposing a Heightened Particularity Requirement for Pleading Loss Causation

Dura and its *amici* contend that it is not enough for investors to plead and prove that misrepresentations and omissions, made with scienter, caused them to pay a fraudulent price. The United States says that §21D(b)(4) requires complaints both to plead loss causation with "particularity" and to provide specifics as to how inflation was "taken out" of a security's price before suit was filed. U.S. Brief at 15.[29]

[29] The United States suggests that Federal Rule of Civil Procedure 9(b) requires this too, but Rule 9(b) requires only that "the circumstances constituting fraud or mistake shall be stated with particularity." With the PSLRA, it requires scienter to be alleged with particularity. 15 U.S.C. §78u-4(b)(2). Although *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 510-13 (2002), acknowledged that under Rule 9(b) averments of "the

Dura thinks that §21D(b)(4) requires much more—a bright-line rule that investors identify specific corrective disclosures (of the truth) corresponding to specific stock price drops (the loss, in their view). Dura's *amici* insist that §21D(b)(4) thus requires the complaint to include expert testimony supported by "[a]n event study . . . 'a statistical regression analysis that examines the effect of an event, such as an allegedly fraudulent statement or omission, on a dependent variable, such as a company's stock price.'"[30]

Such notions find no support at all in §21D(b)'s statutory text which, on its face, imposes particularized pleading requirements for falsity and scienter allegations, but imposes no burden of *pleading* loss causation. *See* 15 U.S.C. §78u-4(b)(1), (2); *Gebhardt v. ConAgra Foods*, 335 F.3d 824, 830 n.3 (8th Cir. 2003).

While §21D(b) specifies certain "Requirements for Securities Fraud Actions," only subsections (1) and (2) purport to impose special pleading standards. First,

> *the complaint shall specify* each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, *the complaint shall state* with particularity all facts on which that belief is formed.

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circumstances constituting fraud" must be "stated with particularity" (*id*. at 513 n.3), there is no requirement that the elements of liability apart from the "circumstances constituting fraud"—*i.e.*, falsity and fraudulent conduct—need be pleaded with particularity.

[30] Securities Industry Ass'n Brief at 9-10 & n.6 (quoting *In re World Access, Inc. Sec. Litig.*, 310 F. Supp. 2d 1281, 1298 n.10 (N.D. Ga. 2004) (granting motion for summary judgment)). The cases cited for this proposition deal with summary judgment or settlement—not pleading standards—and one of them actually *rejects* the S.I.A.'s position that plaintiffs must show a decline in price on disclosure: *In re Executive Telecard Sec. Litig.*, 979 F. Supp. 1021, 1028-29 (S.D.N.Y. 1997).

15 U.S.C. §78u-4(b)(1) (emphasis added). Thus, investors must plead in detail facts explaining why a statement was materially misleading—a significant burden in light of this Court's holdings that plaintiffs must demonstrate "'a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" *Basic*, 485 U.S. at 231 (quoting *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Second, with respect to fraudulent intent, Congress again specified that

> the *complaint shall*, with respect to each act or omission alleged to violate this title, *state with particularity* facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. §78u-4(b)(2) (emphasis added).

"This is not an easy standard to comply with—it was not intended to be—and plaintiffs must be held to it." *Eminence Capital, L.L.C. v. Aspeon, Inc.*, 316 F.3d 1048, 1052 (9th Cir. 2003). Following the pleading requirements of subsections (b)(1) and (b)(2), indeed, is subsection (b)(3)'s command that "the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met." 15 U.S.C. §78u-4(b)(3). No one can accuse the Ninth Circuit of failing to honor this command. *See, e.g., DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir. 2002); *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999).

When the complaint *survives* such a motion, however, subsection (4) specifies that the plaintiff then "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." 15 U.S.C. §78u-4(b)(4) (emphasis added). Congress did not detail how this proof must ultimately be presented, let alone command it must be adduced *at the pleading stage*. Subsection (b)(4) simply "does not deal with pleading." *EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 883 (3d Cir. 2000); *see Gebhardt*, 335 F.3d at 830 n.3; *In re Elec. Data Sys. Corp. Sec. Litig*., 298 F. Supp. 2d 544, 560 (E.D. Tex. 2004). If anything, the statute's text rather clearly indicates that loss causation is something to be dealt with only *after* a plaintiff has met the PSLRA's strict pleading requirements, set forth in subsections (1) and (2).

For the burden of *pleading* and the burden of *proving* are two different things, and the statute's drafters specified quite clearly what must be pleaded. Unlike §21D(b)'s first two subparagraphs, the one requiring plaintiffs *to prove* loss causation says nothing about what *the complaint* must *plead*—only that plaintiffs who have met the preceding pleading requirements must eventually *prove* loss causation. "'Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.'" *Gozlon-Peretz v. United States*, 498 U.S. 395, 404 (1991) (quoting *Russello v. United States*, 464 U.S. 16, 23 (1983)). Moreover, had Congress meant to increase the pleading requirements for loss causation, it surely would have said so: "*Expressio unius est exclusio alterius*." *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993); *accord, e.g.*, *Swierkiewicz*, 534 U.S. at 513; *TRW Inc. v. Andrews*, 534 U.S. 19, 28 (2001).

Generally speaking, "'when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.'" *Lamie v. United States Tr.*, 540 U.S. 526, 124 S. Ct. 1023, 1030 (2004) (citation omitted). And here, leaving loss causation for proof at trial makes sense. Under the PSLRA, private securities fraud plaintiffs generally are foreclosed from pursuing discovery against the defendants until *after* their complaint has survived a motion to dismiss. 15 U.S.C. §78u-4(b)(3)(B). And yet discovery—and expert testimony—may be needed to determine the impact of accounting manipulations on reported results, and thus on stock price.

Even when fraud has been established, it may be very difficult to untangle with precision what portion of a stock's initial inflation and later decline is attributable to which misstatement and what corrective disclosure. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975) (noting that "the damages suffered by purchasers and sellers pursuing a §10(b) cause of action may on occasion be difficult to ascertain"). This Court noted in *Basic* that "there may be a certain incongruity between the assumption that Basic shares are traded on a well-developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements." 485 U.S. at 248 n.29. "Proof of that sort is a matter for trial," *id.*, inappropriate for a contest on the pleadings.[31] It presents complex issues requiring expert testimony, ill-suited to determination on the pleadings.

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[31] *See*, *e.g.*, *Gebhardt*, 335 F.3d at 832 ("we decline to attach dispositive significance to the stock's price movements absent sufficient facts and expert testimony, which cannot be considered at this procedural juncture"); *Huddleston*, 640 F.2d at 553-54 (in securities cases, "amount of damages is a jury issue although the services of a special master or the testimony of an expert witness . . . may be particularly helpful"); *Blackie*, 524 F.2d at 909 n.25 ("The fact finder may rely on other methods of determining actual value on the date of purchase, including expert testimony . . . ."); *see also* Brief for the Securities and Exchange Commission as *Amicus Curiae* in *Basic Inc. v. Levinson*, No. 86-279, at 27 n.34 ("While the fraud on the market theory permits a presumption that material misstatements affected the market price, the plaintiff retains the burden of establishing, in a manner that will vary from case to case, the *amount* of his damages.").

B. The PSLRA's Amendment to Section 12 of the 1933 Act, Which Provides for Recissory Awards, Does Not Apply to Section 10(b) Actions to Recover Out-of-Pocket Losses

Dura and the United States insist the PSLRA's amendment to §12 of the Securities Act of 1933 somehow changed loss-causation rules for 1934 Act claims. Yet courts have long held that fundamentally different rules apply under the 1933 Act, which affords rescissory relief to investors who purchase new stock issues, and the 1934 Act's provisions dealing with fraud and manipulation in the after-market—where courts have always focused on the loss suffered when investors pay a manipulated price.[32]

As originally enacted in 1933, §11(e) and §12(2) both provided for rescission and restitution upon plaintiff's tender of the security, "or for damages" if the security had been sold.[33] "Even in the latter situation, we may assume that a rescissory measure of damages will be employed," with damages "'to be measured so as to result in the substantial equivalent of rescission.'" *Randall*, 478 U.S. at 655-56 (quoting L. Loss, *Fundamentals of Securities Regulation* 1020 (1983)); *see also Hoxworth*, 903 F.2d at 203 n.25. This, of course, made those who issued or sold securities pursuant to a misleading registration statement or prospectus insurers against market losses unrelated to their statutory violations: "Congress shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud." *Randall*, 478 U.S. at 659 (discussing §12 liability).

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[32] *See* Michael J. Kaufman, *Loss Causation Revisited*, 32 Sec. Reg. L. J. 357, 370-74 (publication forthcoming winter 2004) (described in Respondents' November 17 letter).

[33] Pub. L. No. 73-22, §11(e), 48 Stat. 74, 83 (1933); Pub. L. No. 73-22, §12(2), 48 Stat. 74, 84 (1933).

With the 1934 Act Congress modified §11(e), but not §12(2), retaining a rescissory measure of damages for §11 while allowing defendants to avoid some of that liability. *See* Securities Act of 1934, Pub. L. No. 73-291, §201(d), 48 Stat. 905, 907-08 (1934) (amending §11). The amendment to §11 retained a *presumption* that §11 plaintiffs are entitled to a recissory award, but added "[t]hat if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable." *Id*. at 908. This permitted the §11 defendant "to reduce the damages so that he will not be liable for damages which he proves had no relation to his misconduct." H.R. Conf. Rep. No. 73-1838, at 41 (1934).[34] Section 12 "was left untouched." *Randall*, 478 U.S. at 661.

Nothing in the statute or its legislative history suggests that the 1934 Act's amendment to §11(e), whose rescissory measure of damages focuses on the difference between price paid (not to exceed the offering price) and value at a later date, meant that a similar rule must govern 1934 Act claims. While this Court observed in 1986 in *Randall* that there is some question as to whether and under what circumstances rescission or a recissory measure of damages may be available under §10(b), it underscored that *Affiliated Ute* had "held that ordinarily 'the correct measure of damages'" for §10(b)

[34] *See* John Hanna, *The Securities Exchange Act of 1934*, 23 Cal. L. Rev. 1, 7-8 (1934). The measure of damages under §11(e) thus allows plaintiffs to recover the post-transaction decline in value of their investments, placing upon defendants the risk of such post-transaction price declines. *See IPO*, 241 F. Supp. 2d at 349-50; *Akerman v. Onyx Communs., Inc.*, 609 F. Supp. 363, 368-69 (S.D.N.Y. 1984), *aff'd in part*, 810 F.2d 336 (2d Cir. 1987).

claims is the "out-of-pocket" loss. *Randall*, 478 U.S. at 661-62 (quoting *Affiliated Ute*, 406 U.S. at 155). Out-of-pocket loss, not a rescissory measure, remained the usual rule for 1934 Act claims. *See supra* §I.C.

Six decades after it amended §11, Congress decided in 1995 to make a similar modification to §12. The Senate Report explains that the 1995 "amendment to Section 12(2) is modeled after Section 11 of the Securities Act, which provides for a similar affirmative defense." S. Rep. No. 104-98, at 23. Did adding §11(e)'s affirmative defense to §12(2) mean that Congress intended thereby to radically revise §10(b) loss-causation principles? Of course not.

In the intervening half century courts and commentators had drawn a sharp distinction between the rescissory remedies provided by 1933 Act sections 11 and 12, on the one hand, and the 1934 Act's out-of-pocket remedies, on the other—holding that rescissory awards are the exception under the 1934 Act, and that the loss proximately caused by aftermarket manipulation and fraud ordinarily is the difference between price and value on the date of the transaction itself.[35] Had Congress meant to change the rule for 1934 Act claims, it would have said so. It did not.

The rule under §11(e) since 1934, and under §12(a)(2) since 1995, is essentially "a modification of rescission," while 1934 Act claimants typically are limited to the difference between "purchase price and the 'value' of the stock on the day of the purchase." Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 329-30,

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[35] *See, e.g.*, *Pommer*, 961 F.2d at 628 (Easterbrook, J., for the court); *Hoxworth*, 903 F.2d at 203 n.25; *Huddleston*, 640 F.2d at 555; *Green*, 541 F.2d at 1341-43 (Sneed, J. concurring); *Elkind v. Liggett & Myers*, 635 F.2d 156, 169 n.25 (2d Cir. 1980); *WPPSS*, 650 F. Supp. at 1355-56; *Akerman*, 609 F. Supp. at 369. *See also* Kaufman, *Loss Causation Revisted*, 32 Sec. Reg. L.J. at 370-74.

335 (Harvard Univ. Press 1991); *see Green*, 541 F.2d at 1341-46. And it is surprising, to say the least, that Dura and its *amici* would contend that 1934 Act claims now are governed by 1933 Act principles. The 1933 Act's rescissory damages rules were designed to have an "in terrorem effect." *Globus v. Law Research Servs., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969). "The doctrines that apply to fraud in the issuance of securities can produce quite spectacular recoveries," Judge Easterbrook and Professor Fischel have observed, precisely because investors are not limited to out-of-pocket loss at the time of purchase—permitting recovery of far larger post-purchase declines. Easterbrook & Fischel, *supra*, at 335-36.

C. The PSLRA's "Look-Back" Damages Cap Supports the Ninth Circuit's Inflated-Purchase Price-Standard

Section 21D(e)(1) places a "look-back" cap on damages an investor might otherwise be entitled to recover under the 1934 Act, by providing that if

> the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security 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.

15 U.S.C. §78u-4(e)(1). Making the "purchase or sale price paid or received" the reference point for the harm suffered shows that this is when Congress sought to fix loss. *See id*. Congress was concerned that "[b]etween the time a misrepresentation is made [and plaintiff purchases] and the time the market receives corrected information, however, the price of the security may rise or fall for reasons unrelated to the alleged fraud." H.R. Conf. Rep. No. 104-369, at 42. Because

damages, *i.e.*, the initial overpayment, may be only a fraction of a stock's subsequent market decline, Congress worried that "[c]alculating damages based on the date corrective information is disclosed may end up substantially overestimating plaintiff's damages."[36] That, of course, was Judge Sneed's concern in *Green*, too.

Dura claims the traditional focus on price inflation at the time of purchase produces "impracticality," because hypothetical plaintiffs might satisfactorily plead loss causation yet recover no damages if the stock price either does not decline, or rebounds within the 90-day "look-back" period to above what they paid. Yet *the very purpose* of the damages cap is to bar relief that plaintiffs might otherwise be able to pursue—and recover—when all the elements of liability have been met. As the Fourth Circuit recently held in *Miller v. Asensio & Co.*, 364 F.3d 223 (4th Cir. 2004), the "*fact* of proximately caused damage and the *amount* of proximately caused damage" involve "separate, although related, inquiries," and the PSLRA itself "suggest[s] a distinction between 'the loss' and the amount for which damages can be recovered by stating that in a Rule 10b-5 action, the plaintiff must prove the defendant's actions caused '*the loss* for which the plaintiff seeks *to recover damages*.'" *Id*. at 230 (court's emphasis) Proximate cause requires "only that the plaintiff show the defendant's conduct was a *substantial* cause of its injury; it is during the subsequent damages inquiry that the exact amount of damages *solely* caused by the defendant's conduct must be calculated." *Id*. at 232 (court's emphasis).

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[36] *Id*. "According to an analysis provided to the Senate Securities Subcommittee, on average, damages in securities litigation comprise approximately 27.7% of market loss." *Id*. The analysis was based on calculating loss and then damages at the time of purchase based on the inflation in the stock as a result of fraud, and eliminating losses caused by other market factors unrelated to the fraud. *Id.*

In addition, §21D(e)(1) says its limitations apply only *when* plaintiffs seek "to establish damages by reference to the market price of a security." 15 U.S.C. §78u-4(e)(1). Congress, and the United States as *amicus* in this case (*see* U.S. Brief at 19-21), thus realize there are *other* ways to establish damages than by pointing to a price drop. If a decline in price on disclosure of the truth is one way of demonstrating inflation and damages, it is not the only way. In *Blackie*, 524 F.2d at 906, cited by this Court in *Basic*, the Ninth Circuit explained the plaintiffs' loss suffered at the time of purchase need not always be connected to a subsequent decline in the security's price:

> [Defendants] contend that the inflation paid must be measured by the change in price after a corrective release. That drop is of course circumstantial evidence of the inflation when purchased, but it is not the exclusive method of measuring inflation. *The fact finder may rely on other methods of determining actual value on the date of purchase, including expert testimony on actual value* . . . . In any event, the drop after a corrective disclosure will not be conclusive of the amount of original inflation . . . .

Id. at 909 n.25 (emphasis added); *accord Knapp*, 90 F.3d at 1437-38 (Wallace J., for the court); *Wool*, 818 F.2d at 1437 & n.3; *Green*, 541 F.2d at 1341-46 (Sneed, J., concurring).

Another reason for the look-back cap was Congressional fear that upon an adverse disclosure a stock may initially overreact.[37] And again, if the drop was to be used as evi-

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[37] In determining the look-back provision was necessary to prevent over-compensation to plaintiffs, Congress considered the "crash component" associated with the disclosure of fraud, *i.e.*, the over-reaction of the market to such news. H.R. Conf. Rep. No. 104-369, at 42. Congress relied on an article that discusses a rebound period of days to weeks, allowing time for the market to absorb the full meaning of the news released and rebound. *Id*.; *see* Baruch Lev and Meiring deVilliers, *Stock*

dence of the inflation per *Blackie*, allowing time for the market to absorb the news—and discount any over-reaction—was thought to provide some further protection to companies, "limit[ing] damages to those losses caused by the fraud and not by other market conditions." S. Rep. No. 104-98, at 28. Congress, as was its prerogative, extended the rebound time to include a full three-month reporting cycle. This was again a policy determination not based on an efficient market or causation.

Here, the 90-day look-back means, at most, that investors who purchased shortly before Dura's November 1998 announcement would have no damages. But those who purchased at higher prices do.[38] Thus, the look-back's cap does not define the relevant loss as one suffered on disclosure.

III. THE DECISIONS HERALDED BY DURA AND ITS *AMICI* AS THE "MAJORITY" RULE ARE ACTUALLY THE FIRST CASES TO DEVIATE FROM THE TRADITIONAL RULE AND THE PSLRA

Far from representing a "majority" rule, as Dura's *amici* would have it, the first case that appears actually to *reject* the traditional rule that loss causation is established by paying an inflated price is *Robbins*, which held in 1997 that "[p]roof of damages under the out-of-pocket rule is not proof of loss causation." 116 F.3d at 1447. Congress could not possibly have intended to codify an opinion issued two years after the PSLRA's passage. *Robbins* noted that "[s]ome courts have held that '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.'"

Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis, 47 Stanford L. Rev. 7, 9-11 (1994).

[38] *See* stock chart tracking the 90-day look-back mean trading price in this case, in the addendum to this brief.

Robbins, 116 F.3d at 1438. Those, of course, are the earlier precedents to which Congress actually looked. *See supra*.

"But the fraud on the market theory, as articulated by the Supreme Court," the Eleventh Circuit continued in *Robbins*, "is used to support a rebuttable presumption of reliance, not a presumption of causation." *Robbins*, 116 F.3d at 1438 (citing *Basic*, 485 U.S. at 241-42). This, of course, ignores what this Court said in *Basic*. It upheld a fraud-on-the-market claim because "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury," and there is "more than one way to demonstrate the causal connection." *Basic*, 485 U.S. at 243. In a fraud-on-the-market case, this Court held, the "'causal nexus can be adequately established indirectly, by proof of materiality, coupled with the common sense that a stock purchaser does not seek to purchase a loss in the form of artificially inflated stock.'" *Basic*, 485 U.S. at 244-45 (quoting *Blackie*, 524 F.2d at 908). The Court's discussion of how defendants might *rebut* the inference of reliance and causation demonstrates that its focus was on stock price at the time of the investor's purchase or sale. *Id*. at 248-49. And the *concepts* of loss causation and transaction causation remain distinct though closely related—since transaction causation is inferred from investors' unwillingness to sustain a loss proximately caused by purchasing inflated stock. *See id*. at 244-45 (quoting *Blackie*, 524 F.2d at 908).

Neither dictum in *Emergent*, 343 F.3d 189, nor decisions requiring investors who cite a decline in price as their loss to connect it to fraud, can justify overthrowing this approach.

Dura's reliance on *Bastian*, 892 F.2d at 683-86, is particularly misplaced. There, plaintiffs said they invested $600,000 in a limited partnership in direct reliance on defendants' false claim of business competence. *Id*. at 682. Within three years the partnership was worthless, apparently due to declining *industry* profits. *Id*. at 684. Plaintiffs never alleged, despite amendment, that defendants' misrepresentations distorted the acquisition price of the securities. *See* Kaufman, *Loss Causation Revisited*, 32 Sec. Reg. L.J. at 367. Plaintiffs claimed it was sufficient that they invested in reliance on defendants' misstatements and that the business later failed, insisting that they had to do nothing more to show a loss caused by fraud. 892 F.2d at 683. Not surprisingly, the court rejected plaintiffs' contention, holding that a business failure for reasons unrelated to the alleged fraud is not a loss proximately caused by that fraud. *Id*. at 684. Judge Posner explained that investors cannot recover a post-purchase decline in market value caused by forces unrelated to fraud. *Id*. at 685.[39]

The Seventh Circuit subsequently clarified that its requirement for proving loss causation in a Rule 10b-5 case "ought not place unrealistic burdens on the plaintiff at the initial pleading stage." *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997). The plaintiff must allege that defendant "made a fraudulent misstatement and that this misstatement was responsible for its damage." *Id*. In Rule 10b-5 cases, moreover, "damages are usually the difference between price of the stock and its value on the date of the

[39] Judge Posner's Broker-Customer hypothetical confirms he was not rejecting recovery for fraud-based inflation:

> Suppose a broker gives false assurances to his customer that an investment is risk-free. In fact it is risky, the risk materializes, the investment is lost. Here there can be no presumption that but for the misrepresentation the customer would have made an equally risky investment. On the contrary, the fact that the broker assured the customer that the investment was free of risk suggests that the customer was looking for a safe investment. Liability in such a case (well illustrated by *Bruschi v. Brown*, *supra*, 876 F.2d at 1527) is therefore consistent with non-liability in a case such as the present.

Bastian, 892 F.2d at 685-86.

transaction if the full truth had been known." *Id.* at 649 n.6.[40] This, of course, is what the Ninth Circuit holds—that "plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." *Knapp*, 90 F.3d at 1438 (Wallace, J., for the court); *see* PA9a (quoting same).

Dura and its *amici* cite *Prosser and Keeton*, and the *Restatement (Second) of Torts*, for the principle that "if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors in no way relate[d] to the representations will not afford any basis for recovery."[41] But this is exactly what the Ninth Circuit holds by focusing on out-of-pocket loss at the time of purchase—to the exclusion of unrelated later declines in value. "Where, as is commonly the case," *Prosser* explains, "the defendant's actionable misrepresentation or non-disclosure induces a transaction that involves the transfer of something of value, courts normally resort to a general measure of damages often referred to as direct damages, and, in addition thereto, will allow such other damages as special or consequential damages as the plaintiff can prove." *Prosser & Keeton*, *supra*, §110, at 766. If an investor seeks to recover as "loss" the difference between what he transferred and what he would have transferred

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[40] In light of *Caremark*, suppose that in *Bastian* the plaintiffs had proved that defendants' misstatements *had* distorted the share price of the partnership causing an overpayment of $25 a share, *i.e.*, from $25 to $50; and plaintiffs had invested $1,200,000 instead of $600,000. Shortly thereafter, the entire industry collapsed and the stock became worthless. Applying Judge Posner's analysis, $25 of the plaintiffs' $50 loss per share ($600,000), is attributable to the industry collapse and cannot be recovered through suit. The other $25 per share should be recoverable because defendants' fraud caused plaintiff to pay too much (inflated price).

[41] *Prosser and Keeton*, *supra*, §110, at 767. The *Restatement* contains a similar example. *Restatement (Second) of Torts* §548A cmt. b.

absent the fraud, that loss is recoverable. Only if the plaintiff seeks *in addition* to recover consequential or special damages, must a subsequent decline in stock value be caused by the fraud. And again, in §10(b) cases such additional damages have generally been denied.

IV. PETITIONERS' BRIGHT-LINE CORRECTIVE-DISCLOSURE PRICE-DECLINE RULE WOULD UNDERMINE THE SECURITIES LAWS' FUNDAMENTAL PURPOSES

By every measure, the U.S. capital markets are the world's largest and strongest.[42] They are so attractive that some 900 foreign companies, from more than 40 different countries, list their securities for trade on our markets—not despite our securities laws, but *because of* them.[43] Private actions, long implied under §10(b), are crucial to the integrity of our disclosure system and markets because they provide a powerful deterrent to fraud, and are a necessary supplement to the

[42] "The U.S. capital markets continue to be the deepest, most liquid, and most efficient markets in the world." *Strengthing Accounting Oversight: Before the House Energy and Commerce Comm*. (July 26, 2002) (testimony by Edmund L. Jenkins, Chairman of the Financial Accounting Standards Board); "[W]e have the deepest and most liquid capital markets in the world." *Corporate Accounting Practices Review: The Rules of the SEC and FASB in Establishing GAAP: Hearing on H.R. 3763 Before the House Fin. Servs. Comm*. (May 14, 2002) (testimony by Robert K. Herdman, SEC Chief Accountant).

[43] *See* Jenkins Congressional testimony, *supra* (United States has deepest and most liquid markets "largely because of the high quality of our financial reporting system"). *See* http://www.nyse.com/pdfs/updatedforlist_041029.pdf (visited Oct. 29, 2004) (460 foreign companies from 47 countries); http://www.nasdaq.com/asp/NonUsOutput.asp (visited Oct. 29, 2004) (340 foreign companies, including eight additional countries not represented on the NYSE).

SEC's enforcement program.[44] Congress clearly recognized this in enacting the PSLRA.[45]

Our securities laws "'embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.'" *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 171 (1994) (quoting *Affiliated Ute*, 406 U.S. at 151). Yet by calling for a rule that sees loss causation only in a decline in price upon disclosure of the truth, Dura and its *amici* ask this Court to create perverse incentives rewarding those who, after perpetrating a fraud, continue concealing the truth. This surely contradicts the 1934 Act's core aim of full *disclosure* and informed markets.

While some securities-fraud cases proceed in simple fashion, with false statements followed by a sudden stock price drop on public revelations that the truth was otherwise, many other securities-fraud cases are not so simple. "Rarely is one outright lie revealed through one correction," leading authorities on event studies tell us, and because it often "is difficult to determine when corrective disclosure occurs," one can "unambiguously define the disclosure date and the associated disclosure price only in simple situations." Cornell & Morgan, *supra*, 37 U.C.L.A. L. Rev. at 889, 891, 896.

Many securities-fraud cases are factually complex. In this case, for example, defendants' (partial) disclosures impacting AlSpiros expectations were part of the original Ceclor CD

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[44] *Hearing on Securities Fraud Litigation Reform Proposals Before the Subcommittee on Telecommunications & Finance of the House Committee on Commerce*, 1, 30 (Feb. 10, 1995) (testimony of SEC Chairman Arthur Levitt).

[45] Contrary to what the Solicitor General and several *amici* say, despite their size and complexity securities cases go to trial about as often as any other type of civil case. Only 1.7% of federal civil cases, in general, actually reach trial according to the most recent *Federal Judicial Caseload Statistics* compiled by the Administrative Office of the United States Courts.

disclosure discussing the sales force inadequacy and then dribbled out for months after the Class Period's close—with the final announcement itself condemned by the FDA months after the Class Period's close.[46] Dura's proposed rule—requiring a decline in price on disclosure of wrongdoing—ignores the fact that defendants who falsified a company's condition, and lied about its finances, products or prospects might refuse to "come clean," never admitting that they said or did anything wrong.

Under the Sarbanes-Oxley Act Congress recently extended the limitations period for §10(b) claims to two years from discovery and *five years from the violation*. Legislative history shows Congress adopted the five-year period of repose precisely because securities fraud is so hard to discern. The statute-of-limitation amendment's co-sponsor, Senator McCain, explained that the existing three-year period was too "short given the complexity of many of these matters, and defrauded investors may be wrongly stopped short in their attempts to recoup their losses under current law. . . . Because this statute of limitations is so short, the worst offenders may avoid accountability and be rewarded if they can successfully cover up their misconduct for merely three years. The more complex the case, the easier it will be for these wrongdoers to get away with fraud." 148 Cong. Rec. S6528-29 (July 10, 2002). He emphasized that "in some cases, the facts of a case simply do not come to light until years after the fraud." *Id*. The amendment's chief sponsor, Senator Leahy, added that "the law should not reward the perpetrator of a fraud, who successfully conceals its existence for more than three years." 148 Cong. Rec. S7418-20 (July 26, 2002).

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[46] JA111a (¶136) (quoting FDA letter described in Respondents' November 17 letter).

Moreover, as noted above, by merely delaying disclosure, those who commit fraud may minimize its apparent impact. *See supra*, n.8. Over time inflation due to fraud ages out of a stock's price. *Id.* A rule that damages must be measured only to the extent of a *subsequent drop* on disclosure of the truth would perversely reward those able to conceal their fraud the longest. If a company reveals that last quarter's revenues were deliberately overstated by 20%—in order to show a profit, when the company had really suffered a loss—one would expect an immediate and strong market reaction. The reason is that future expectations are based, in part, on what is currently believed the base to grow on. A 20% overstatement in the quarter just completed would render the market's discounted cash flow models flawed and overstated. The stock would tumble. If the company waits several years before finally admitting to the fraud, the impact will not be the same—even if it discloses that its revenues were deliberately inflated for a single quarter four-and-a-half years ago. Like the headline of a recent article in *The New York Times* says: "Yesterday's Earnings Don't Move Stocks, Tomorrow's Do," Jonathan Fuerbringer, *N.Y. Times*, Aug. 8, 2004; *see also* Lynn Cowan & Shaheen Pasha, "Investors Focus on Future Results and Forgive Past Performance," *Wall St. J.*, Apr. 24, 2002; NERA Presentation, *supra*, n.8.[47]

Dura ignores something more: "Executives can be marvelously creative when they have to disclose disappointing

[47] The Securities Industry Association complains that the Ninth Circuit's refusal to require a corrective disclosure followed by a stock drop would allow plaintiffs to survive a Rule 12(b)(6) motion to dismiss in a situation wherein a $200 investment gradually declines to $20—and remains at $20, despite the defendant's sudden announcement of an accounting restatement. Securities Industry Ass'n Brief at 3. Our response, however, is simple. If the stock was really worth $100 but investors paid $200, investors should recover the $100 overpayment. Otherwise insiders that inflated the stock price and cashed out can immunize themselves with additional false statements and/or delay.

results to investors." Gretchen Morgenson, "Finding Holes in Corporate Excuses," *N.Y. Times*, Aug. 1, 2004. A disclosure's negative effect may be obscured by defendants who downplay its significance, who pair the bad news with good, *or who lie again*. *See, e.g.*, *No. 84 Employer-Teamster Joint Council Pension Tr. Fund v. Am. West Holding Corp.*, 320 F.3d 920, 934-35 (9th Cir. 2003); *Gray v. First Winthrop Corp.*, 82 F.3d 877, 882-83, 886 (9th Cir. 1996); *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 966 (7th Cir. 1989) ("a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counterbalancing the loss") (Easterbrook, J.). Here, of course, Dura's November 3, 1998, press release downplayed the product's failure so blatantly that the FDA cited it. JA110a-111a (¶136); *see* Nov. 6, 1998, FDA letter.

Thus, Dura's proposed rule would give those who choose to commit fraud many opportunities to game the system, and to avoid liability with manipulative disclosures. *See* Eisenhofer, *supra*, 59 Bus. Law. at 1443.

The loss-causation issue is in play only if a defendant has already told one lie, *i.e.*, a lie that inflated the price of the stock for some period of time while investors were purchasing it. Telling two lies will, under the bright-line causation rule sought by petitioners and their *amici*, allow lying insiders to avoid liability. There is no room under our securities laws for a rule that encourages corporate insiders to tell a second lie to avoid liability for their first lie. Yet, that is exactly what the loss-causation rule argued for by Dura and its *amici* would produce.

For example, a stock may decline, before any disclosure, as insiders bail out. In *Dirks v. SEC*, 463 U.S. 646 (1983), this Court noted that surreptitious stock sales by investors with access to adverse inside information regarding a company's accounting improprieties drove its stock from $26 per share to less than $15 per share in two weeks—causing the New

York Stock Exchange to halt trading—before any public disclosure of the accounting fraud. *Id.* at 649-50; *see Dirks v. SEC*, 681 F.2d 824, 831-32 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983). In *SEC v. Shapiro*, 494 F.2d 1301, 1307 n.3 (2d Cir. 1974), trading by insiders who knew of undisclosed favorable information "pushed the price of [the] stock by February 18 to nearly three-and-one-half times what it had been at the beginning of the year."

Petitioners' proposed rules could make it hardest for victims of the most egregious frauds to plead a claim. Such rules should be rejected.

CONCLUSION

The statute at issue in this case is plain on its face: It does not raise the pleading standards as to loss causation in open-market fraud cases. Moreover, there is more than one way to prove loss causation—which traditionally requires a showing only that the price paid was inflated by fraud at the time of the transaction. A contrary rule, that allows defendants to reduce liability through continued misrepresentations or concealment, should be flatly rejected. The judgment of the Ninth Circuit should be affirmed.

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