Cause for Concern: Causation and Federal Securities Fraud

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A*BSTRACT*: *The Supreme Court's decision in* Dura Pharmaceuticals *dramatically changed federal securities fraud litigation. The* Dura *decision itself said little, but counseled lower courts to fashion new requirements of causation and harm modeled upon common law tort principles. These instructions have led lower courts to craft a series of confusing and inconsistent decisions that incorporate little of the reasoning upon which the common law principles are based.*

This Article accepts the Dura *challenge and examines both common law causation principles and their applicability to federal securities fraud. In so doing, the Article identifies the failure of the federal courts to confront properly the complex causation challenges presented by securities fraud and the extent to which common law approaches to multiple and indeterminate causation offer guidance. Common law causation analysis further highlights the critical issue of harm specification. The Article demonstrates how, from* Basic *to* Dura*, the Supreme Court has refused to address the issue of what constitutes an appropriate economic loss, despite the fact that this determination is a necessary predicate to formulating a causation requirement. The Article goes on to show how, in* Basic*, the Court shifted the nature of actionable harm and, in so doing, exacerbated the complexity of causation analysis.*

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Defining the appropriate harm involved in securities fraud is challenging. Drawing upon tort law principles, this Article considers several alternatives, including artificial price inflation, ex post stock price drop, and increased investment risk. The choice among these alternatives reflects policy judgments about the appropriate goals of private securities fraud litigation. In its final section, this Article considers current critiques of securities fraud litigation and demonstrates how these concerns should influence the scope of the private right of action.

I. INTRODUCTION

In 2005, the U.S. Supreme Court considered the scope of the loss causation requirement in federal securities fraud litigation. In *Dura Pharmaceuticals, Inc. v. Broudo,*[1] the Court explained that, in formulating the causation requirement, the lower courts should look to the common law for guidance. As the *Dura* Court stated, the "traditional elements of causation and loss"[2] are derived from "common-law deceit and misrepresentation actions."[3]

Three years later, the Supreme Court decided another case involving federal securities fraud. In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the Court rejected a claim by investors against secondary defendants on the ground that the investors could not meet the reliance requirement.[4] In so doing, the Court explicitly rejected an interpretation of the reliance requirement based on common law fraud. According to the Court: "Section 10(b) does not incorporate common-law fraud into federal law."[5]

Reliance and loss causation constitute two components of the causation requirement in federal securities fraud, a requirement that the lower courts have refined over many years based on common law tort principles.[6] The very terms used by the federal courts in analyzing causation—"transaction causation" and "loss causation"—have their roots in the common law. Moreover, the incorporation of tort law into federal securities fraud extends beyond causation; most of the elements of federal securities fraud draw upon common law torts. Thus, with its two conflicting approaches, the Court has thrown into question a critical interpretive principle.

Legal realists might point to *Dura* and *Stoneridge* as evidence that the Justices' desired outcomes dominate principled legal analysis. Neither decision fully analyzes the common law principles at issue, yet both reach

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1. Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005).

2. *Id.* at 346.

3. *Id.* at 343. Detailed causation analysis in common law fraud cases is quite limited. Complex questions of causation are more commonly found in negligence law. For example, *Dura* cites comment b to section 548A of the *Restatement (Second) of Torts, see id.* at 344, which contains a brief discussion of legal causation in cases of fraudulent misrepresentation and notes the existence of conflicting authority as to the scope of the defendant's responsibility. *See* RESTATEMENT (SECOND) OF TORTS § 548A cmt. b (1977); *id.* § 548A reporter's note (1981).

4. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 769 (2008) ("Petitioner . . . cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability.").

5. *Id.* at 771.

6. Congress codified the loss causation requirement as part of the Private Securities Litigation Reform Act of 1995 without defining loss causation or evidencing any intention to depart from the existing judge-made definition. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, sec. 101(b), § 21D(b)(4), 109 Stat. 737, 747 (codified at 15 U.S.C. § 78u-4(b)(4) (2000)).

the same policy outcome of restricting private litigation. In *Dura*, the Court drew upon tort law to reject the argument that artificial price inflation was sufficient to establish the plaintiffs' loss. In *Stoneridge*, the Court rejected tort law in order to dismiss claims against defendants who had not made misstatements directly to investors. Yet, legal realism fails to do justice to an underlying tension in the scope of the private right of action for federal securities fraud—a tension that, this Article claims, is properly understood as the cause of the Court's schizophrenia. Federal securities fraud is—at the same time—both like and unlike the common law torts upon which it is based. As a result, the nature of the claim and the policies it serves offer reasons both to reject and to embrace analogies to the common law.

The context of the causation requirement highlights this tension. A careful analysis of the common law reveals two important issues that the courts' causation analysis has not addressed. The first is the effect of multiple causal factors. The Supreme Court's decision in *Basic Inc. v. Levinson*[7] makes it critical to determine the effect of the fraud upon stock price, yet multiple nontortious factors also affect stock price. In considering the legal effect of these multiple causal factors, courts have failed to incorporate tort law principles that allocate responsibility in cases of indeterminate, duplicate, or overdetermined causation.

The complex causation cases in tort law reveal a critical connection between causation and harm. Under the common law, tortious conduct is actionable only to the extent that it causes harm, and the plaintiff can recover only for harms resulting from the risk created by the tortious conduct. The causation requirement thus mediates between the defendant's conduct and the plaintiff's claimed injury, ensuring that there is a sufficient connection between the two to justify holding the defendant legally accountable. As a result, precise specification of the nature of the injury or harm is necessary. Harm specification has, however, received relatively little attention in the context of federal securities fraud. The Court's decision in *Basic* dramatically reformed the nature of private securities fraud claims, shifting the nature of recoverable harm without considering the implications of this shift. Both *Dura* and *Stoneridge* reflect the fallout from that decision.

This Article accepts the challenge posed by *Dura* and *Stoneridge*. The Article conducts the analysis referenced, but never actually performed, by the Supreme Court and applies common law tort principles to causation analysis in federal securities fraud. In so doing, the Article demonstrates that the federal courts have failed fully to utilize the extensive common law principles developed by tort theorists to address complex causation issues. The application of these principles requires a more careful specification of harm. As a result, this Article considers the question posed by the *Dura* Court: What constitutes an appropriate economic loss?

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7. Basic Inc. v. Levinson, 485 U.S. 224 (1988).

The extensive policy debate over private securities fraud litigation offers new reason to consider this question. Commentators have argued that the class action—the most common post-*Basic* form of private litigation—is largely ineffective in achieving either compensation of injured victims or deterrence of wrongful conduct, the traditional objectives of tort law. In light of these concerns, many critics have urged that private litigation be substantially reduced or eliminated. The Supreme Court's recent causation analysis can be understood as an unarticulated response to those concerns. At the same time, *Basic* reflects a shift away from the traditional tort context in order to address broader issues of market protection. Ultimately, the applicability of common law principles and the appropriate scope of the causation requirement depend upon the extent to which this shift is defensible.

The Article begins in Part II by briefly reviewing the causation requirement in federal securities fraud and its common law roots. In Part III, the Article examines causation in common law torts, including the analysis of complex causation questions. This analysis demonstrates the critical role of harm specification. In Part IV, the Article turns to that issue, exploring the *Dura* Court's rejection of artificial price inflation as a legally actionable harm and considering possible alternatives. In so doing, the Article considers the crucial shift in recoverable harm effected by the *Basic* decision. Part V offers some thoughts on the broader policy question of the appropriate scope of the federal statutory remedy for securities fraud in light of market and other developments and demonstrates the interdependency between this question and the causation requirement.

II. THE CAUSATION REQUIREMENT IN 10b-5 LITIGATION

Although federal securities fraud is a statutory claim, it functions largely like a common law tort claim.[8] The federal courts have recognized an implied private right of action under section 10(b) of the Securities Exchange Act[9] and SEC Rule 10b-5,[10] and have used federal common law to define the contours of the cause of action.[11] Thus, the elements of a federal securities fraud claim, including the causation requirement, are largely judge-made law. In 1995, however, Congress codified the loss causation requirement.[12]

8. *See* Louis Loss, Commentary, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 910–11 (1992) (explaining how courts have "develop[ed] a new federal tort from section 10(b) and rule 10b-5, . . . [and] invok[ed] *Erie*-resistant federal common law in order to invent appropriate qualifications of the new tort").

9. Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2000)).

10. 17 C.F.R. § 240.10b-5 (2008).

11. *See supra* note 8 and accompanying text.

12. *See supra* note 6.

Causation analysis has grown in importance. Twice in the last several years, the causation requirement has made its way to the Supreme Court. In 2005, the Court addressed loss causation in *Dura*.[13] Last term, the Court increased the significance of reliance in *Stoneridge*.[14] Notwithstanding this attention, the parameters of the causation requirement remain unclear.

A. *THE DEVELOPMENT OF THE CAUSATION REQUIREMENT*

The Second Circuit's 1974 decision in *Schlick v. Penn-Dixie Cement Corp.*[15] is widely cited as the first case to formalize the causation requirement.[16] In fact, several earlier cases drew upon principles of common law tort to articulate a requirement of reliance and/or causation in fact.[17] *List v. Fashion Park, Inc.*, for example, used the substantial-factor test of the *Restatement of Torts* in defining the reliance requirement.[18]

Schlick, however, is credited with establishing the causation requirement because the court originated the causation terminology that is now in widespread use.[19] The court—citing almost no authority—explained that causation consists of two distinct components: "loss causation" and "transaction causation."[20] Loss causation requires the plaintiff to show "that the misrepresentations or omissions caused the economic harm."[21] Transaction causation involves showing "that the violations in question caused the [plaintiff] to engage in the transaction in question."[22] Subsequent courts have analogized loss causation to proximate or legal

13. Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005).

14. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).

15. Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974).

16. *See, e.g.*, Weisberg v. Coastal States Gas Corp., 609 F.2d 650, 654 n.2 (2d Cir. 1979) ("The term 'transaction causation' was apparently first used in this court by Judge Oakes in *Schlick* . . . ."); David S. Escoffery, Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 FORDHAM L. REV. 1781, 1793 (2000) ("*Schlick v. Penn-Dixie Cement Corp.* was the first case to ever make a distinction between transaction causation and loss causation." (footnote omitted)).

17. *See, e.g.*, List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965) ("Our examination of the authorities satisfies us that [the common law reliance] requirement also is carried over into civil suits under Rule 10b-5.").

18. *Id.* at 462 (quoting RESTATEMENT OF TORTS § 546 (1938)); *see also infra* notes 148–49 and accompanying text (discussing the substantial-factor test).

19. *See* Escoffery, *supra* note 16, at 1793 (attributing this terminology to the court in *Schlick*).

20. *Schlick*, 507 F.2d at 380.

21. *Id.*

22. *Id.* Significantly, Judge Frankel wrote separately to question the majority's decision to employ these terms, observing that although they had "some scholarly currency," their use was unnecessary and the implications of employing them were "still uncertain." *Id.* at 384 (Frankel, J., concurring).

cause, while they analogize transaction causation to "but-for" or factual cause.[23]

Significantly, the *Schlick* opinion addressed only the sufficiency of the pleadings.[24] In addition, the *Schlick* court viewed transaction causation as the more demanding aspect of the causation requirement.[25] The court did not explore the concept of loss causation in detail, concluding simply that it was "demonstrated rather easily by proof of some form of economic damage."[26] Finally, in keeping with earlier causation decisions, *Schlick* specifically distinguished the causation requirement in the securities fraud context from its tort law predecessor, concluding that a strict causation requirement was inappropriate in light of the "broad remedial purposes" of the federal securities laws.[27]

For a number of years, reliance—now termed "transaction causation"—received more attention in securities fraud cases than did loss causation. Analogizing to common law fraud, courts required plaintiffs to establish transaction causation by proving actual reliance.[28] This requirement presented a challenge because plaintiffs essentially had to show that they would have behaved differently as a result of information that they did not actually have. The requirement was particularly burdensome in nondisclosure cases. The Supreme Court addressed the issue in *Affiliated Ute Citizens v. United States* and determined that plaintiffs could establish reliance in such cases by proof of materiality.[29]

The *Affiliated Ute* decision greatly simplified the reliance analysis in subsequent omissions cases. For example, in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, the Second Circuit explicitly rejected the defendant's argument that "it is still necessary to show a 'connection' between defendants' non-disclosure conduct and plaintiffs' purchase of [the] stock—in the sense that the former induced the latter—before a Rule 10b-5 claim

23. *See, e.g.*, Berckeley Inv. Group, Ltd. v. Colkitt, 455 F.3d 195, 222 (3d Cir. 2006) (stating that loss causation is "[s]imilar to the concept of proximate cause in the tort context"); AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 228–29 (2d Cir. 2000) (Winter, C.J., dissenting) (describing transaction causation as "whether the fraud here was a but-for cause of appellants' losses"). It is not clear that this formulation is consistent with the original tort law conception. *See infra* Part III (discussing causation under tort law); *see also* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 42, at 273 (5th ed. 1984) (arguing that proximate cause deals with the question of legal responsibility and, as such, is "not a question of causation, or even a question of fact").

24. *See Schlick*, 507 F.2d at 376 (noting that the appeal was from a complaint dismissal).

25. *Id.* at 380.

26. *Id.*

27. *Id.* at 383 (internal quotation marks omitted).

28. *See* Theresa A. Gabaldon, *Unclean Hands and Self-Inflicted Wounds: The Significance of Plaintiff Conduct in Actions for Misrepresentation Under Rule 10b-5*, 71 MINN. L. REV. 317, 320–21 (1986) (describing the actual-reliance requirement).

29. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153–54 (1972).

can be established."[30] Rather, the court concluded that "the requisite element of causation in fact has been established by the admitted withholding by defendants of material inside information which they were under an obligation to disclose."[31]

Affiliated Ute did not go far enough, however. The reliance requirement continued to serve as an obstacle. In part, the problem was that reliance was an individualized question that prevented the use of the class action mechanism. At the same time, the requirement was in tension with the nature of market transactions in publicly traded securities, because individual investors did not engage in face-to-face transactions with fraudsters, and fraudulent statements were often intermediated through brokers, research analysts, and the media before reaching the investing public.[32]

Ultimately, the Supreme Court addressed these concerns in *Basic Inc. v. Levinson*.[33] In *Basic*, the Court accepted the fraud-on-the-market ("FOTM") theory as creating a rebuttable presumption of reliance when "materially misleading statements have been disseminated into an impersonal, well-developed market for securities."[34] Importantly, the *Basic* Court distinguished federal securities fraud from common law fraud in its analysis of the reliance requirement, concluding that in securities cases—unlike in traditional face-to-face transactions—"'the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price.'"[35] Accordingly, the Court concluded that investors could establish reliance by proof that they relied on the integrity of the market price rather than on the fraudulent statements themselves, and that it was sufficient, for purposes of the reliance requirement, for plaintiffs to establish that the fraudulent statements distorted the market price.[36]

Basic dramatically facilitated the use of class action litigation in securities fraud cases. In turn, this development changed the economics of securities fraud litigation. Class action suits made it economically feasible to bring claims on behalf of small investors, and the aggregated claims were, in some cases, very large.[37] Large claims offered a basis for higher attorneys'

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30. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 239–40 (2d Cir. 1974).

31. *Id.* at 240.

32. *See, e.g.*, Panzirer v. Wolf, 663 F.2d 365, 366–67 (2d Cir. 1981) (describing claims by an investor who did not read the fraudulent annual report but instead based her investment decision on a *Wall Street Journal* column's report of analyst opinions).

33. Basic Inc. v. Levinson, 485 U.S. 224 (1988).

34. *Id.* at 247.

35. *Id.* at 243–44 (quoting *In re* LTV Sec. Litig., 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

36. *See id.* at 245–47.

37. *See, e.g.*, A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 948 (1999) ("[T]he presumption in fact produced an enormous increase in liability exposure for corporate issuers. . . . Under the fraud

fees, motivating entrepreneurial lawyers to specialize in securities fraud litigation.[38] Even weak cases often settled because of the high costs of defending the case, and these settlements created an incentive for some lawyers to file fraud complaints predicated on little more than an issuer's disclosure of negative information coupled with a drop in the stock price.[39] The perception that some lawyers frequently used class actions to bring frivolous cases solely for their settlement value led to concerns about litigation abuse and demands for reform.

One consequence of these concerns was increased judicial attention to the element of loss causation. If *Basic* had opened the litigation floodgates by relaxing the reliance requirement, perhaps courts could use loss causation to close them. Lower courts struggled with both the terminology and the parameters of the loss causation requirement.[40] The starting point was to distinguish the two components of causation. In so doing, many courts[41] cited the illustration offered by the Fifth Circuit in *Huddleston v. Herman & MacLean*:

> For example, an investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel had a certain capacity when in fact it had less capacity than was represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as a result of a casualty and the stock becomes worthless. In such circumstances, a fact-finder might conclude that the misrepresentation was material and relied upon by the investor but that it did not cause the loss.[42]

Although the example is cogent, the basis for incorporating these two requirements into federal securities fraud is unclear. The *Huddleston*

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on the market presumption, typical damages exposure will be in the tens or hundreds of millions of dollars.").

38. *See generally* John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987) (describing the role of entrepreneurial plaintiffs' lawyers).

39. *See* Joel Seligman, Commentary, *The Merits Do Matter: A Comment on Professor Grundfest's* "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority," 108 HARV. L. REV. 438, 442–45 (1994) (describing congressional testimony about securities fraud litigation premised on a drop in stock price).

40. *See, e.g.*, Bastian v. Petren Res. Corp., 892 F.2d 680, 685 (7th Cir. 1990) (Posner, J.) (describing "loss causation" as "an exotic name—perhaps an unhappy one"); LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 931 (7th Cir. 1988) (Easterbrook, J.) (describing the terms "loss causation" and "transaction causation" as "ungainly" and "confusing").

41. *See, e.g.*, *In re* Wash. Pub. Power Supply Sys. Sec. Litig., 650 F. Supp. 1346, 1353–54 (W.D. Wash. 1986).

42. Huddleston v. Herman & MacLean, 640 F.2d 534, 549 n.25 (5th Cir. Unit A Mar. 1981), *aff'd in part, rev'd in part*, 459 U.S. 375 (1983).

decision expressly analogized to common law tort principles—explaining that reliance is "a type of 'but for' requirement" and that causation involves "proximate cause."[43] The only authority it cited for incorporating a distinct loss causation requirement into a federal securities fraud claim, however, was the dissenting opinion of Judge Meskill in *Marbury Management, Inc. v. Kohn*.[44] Judge Meskill cited to common law tort authorities—*Prosser on Torts* and the *Restatement (Second) of Torts* ("*Second Restatement*")—in support of his analysis.[45] The majority in *Marbury Management*, however, rejected Judge Meskill's analysis. The majority explained that "[d]ifferentiating transaction causation from loss causation can be a helpful analytical procedure only so long as it does not become a new rule effectively limiting recovery for fraudulently induced securities transactions to instances of fraudulent representations about the value characteristics of the securities dealt in."[46] Recent decisions have favored Judge Meskill's analysis and the *Huddleston* distinction over the approach of the *Marbury Management* majority.[47]

Responding to policy concerns over excessive litigation, the courts invigorated the loss causation requirement. Opinions describe this requirement in various ways, most of which borrow both conceptually and linguistically from tort law.[48] The stricter formulations emphasize loss causation's foundation in the tort law requirement of proximate cause. These approaches require the plaintiff to show that the defendant's fraud caused the loss "'in some reasonably direct, or proximate, way'"[49] or that "the subject of the fraudulent statement or omission was the cause of the actual loss suffered."[50] Other approaches are more policy-oriented. The "materialization of the risk" approach, for example, requires the plaintiff to prove that his loss "was caused by the materialization of a risk that was not disclosed because of the defendant's fraud."[51] The Fifth Circuit explained in *Huddleston* that loss causation is established "only if the misrepresentation

43. *Id.* at 549.

44. *See id.* (citing Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting)).

45. *Marbury Mgmt.*, 629 F.2d at 718–19 (Meskill, J., dissenting).

46. *Id.* at 710 n.3 (majority opinion).

47. *See, e.g.*, Currie v. Cayman Res. Corp., 835 F.2d 780, 785 (11th Cir. 1988) (citing *Huddleston* and Judge Meskill's dissent in *Marbury Management* in explaining the loss causation requirement).

48. Although some commentators have characterized these formulations as distinct tests, such a characterization may be misleading in that courts have frequently shifted from one formulation to another within the contours of the same opinion.

49. Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997) (quoting *Huddleston*, 640 F.2d at 549).

50. Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 95 (2d Cir. 2001).

51. *Id.* at 98 n.1 (describing this approach—which is employed by the Seventh Circuit—as "both principled and predictable," but concluding that prior Second Circuit precedents barred its adoption).

touches upon the reasons for the investment's decline in value."[52] Similarly, some courts have looked to whether the loss suffered was a foreseeable result of the defendant's fraudulent conduct.[53]

Loss causation analysis complicates securities fraud litigation because of the myriad factors that affect the value of securities investments. The analysis depends, in part, on how the plaintiff's loss is measured, an issue that this Article considers in more detail in Part IV below. Prior to *Dura*, some courts recognized artificial price inflation—the amount by which plaintiffs overpaid for securities, the price of which had been inflated by fraud—as an actionable loss.[54] Expert witnesses offered testimony as to the effect of the fraud on the purchase price—the amount by which the defendants' fraud had caused the plaintiffs to overpay.[55] An alternative formulation of the loss looked to the amount by which the stock price dropped when the fraud was revealed to the market.[56] This approach complicated the analysis because many nonfraudulent events impacted the stock price between the misstatement and the corrective disclosure, requiring the court to ascertain the extent to which a subsequent decline in stock price resulted from the fraud as opposed to other factors.[57]

Congress's decision to codify the loss causation requirement in the Private Securities Litigation Reform Act of 1995 ("PSLRA") endorsed, and perhaps enhanced, judicial development of the loss causation requirement.[58] The PSLRA was the result of a multi-year effort to reduce

52. *Huddleston*, 640 F.2d at 549.

53. *See, e.g.*, Citibank, N.A. v. K-H Corp., 968 F.2d 1489, 1495 (2d Cir. 1992) (stating that the plaintiff's economic harm must be "a foreseeable consequence of the misrepresentation").

54. Indeed, the Ninth Circuit took this approach in *Dura*. *See* Broudo v. Dura Pharms., Inc., 339 F.3d 933, 937–39 (9th Cir. 2003), *rev'd*, 544 U.S. 336 (2005).

55. *See* Jay W. Eisenhofer et al., *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 BUS. LAW. 1419, 1434–37 (2004) (describing the calculation of damages based on artificial price inflation).

56. *See, e.g.*, Robbins v. Koger Props., Inc., 116 F.3d 1441, 1448 (11th Cir. 1997) ("[A] showing of price inflation . . . does not satisfy the loss causation requirement. . . . Our decisions explicitly require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value."); Eisenhofer et al., *supra* note 55, at 1431–34 (describing calculation of damages based on the decline in stock price after disclosure of the fraud).

57. *See, e.g.*, *In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 364–65 (S.D.N.Y. 2003) (describing intervening factors that may constitute alternative causes of stock price decline, such as recession, industry decline, and other marketwide phenomena), *aff'd sub nom.* Lentell v. Merrill Lynch & Co., 396 F.3d 161 (2d Cir. 2005); *see also* Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 189 (2d Cir. 2001) ("'[W]hen factors other than the defendant's fraud are an intervening direct cause of a plaintiff's injury, that same injury cannot be said to have occurred by reason of the defendant's actions.'" (quoting First Nationwide Bank v. Gelt Funding Corp., 27 F.3d 763, 769 (2d Cir. 1994))).

58. *See supra* note 6.

abusive and frivolous securities fraud litigation.[59] Among the features of the statute were a heightened pleading requirement for scienter; an effort to eliminate lawyer-driven litigation and the so-called race to the courthouse by, among other things, establishing a statutory lead plaintiff; and the replacement of joint and several liability with proportionate liability for secondary defendants.[60] With respect to loss causation, the PSLRA added section 21D(b)(4) to the Securities Exchange Act of 1934.[61] The section provides that "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages."[62]

Although the legislative history of the PSLRA is extensive, the legislative record provides far greater detail on the nature and extent of the perceived problem that the statute addressed than on the intended operation of the statutory solutions.[63] It is clear that Congress intended, in section 21D(b)(4), to codify some version of the loss causation requirement that the courts had previously developed and, through that requirement, to provide a limiting principle for calculation of the plaintiff's losses.[64] Congress also clarified that loss causation was a required element of the plaintiff's case, as opposed to an affirmative defense for which the defendant would bear the burden of proof.[65] Congress did not, however, elaborate on the nature of the loss causation requirement.[66]

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59. The statute had its origins in the Republican *Contract with America*, which targeted excesses in litigation. *See* CONTRACT WITH AMERICA: THE BOLD PLAN BY REP. NEWT GINGRICH, REP. DICK ARMEY, AND THE HOUSE REPUBLICANS TO CHANGE THE NATION 143–55 (Ed Gillespie & Bob Schellhas eds., 1994) (describing problems caused by attorney control of litigation process). For a brief summary of the history and scope of the PSLRA, see Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 534–37 (1997); Escoffery, *supra* note 16, at 1810–12.

60. *See* Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1304 (1999) (describing provisions of the PSLRA).

61. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, sec. 101(b), § 21D(b)(4), 109 Stat. 737, 747 (codified at 15 U.S.C. § 78u-4(b)(4) (2000)).

62. 15 U.S.C. § 78u-4(b)(4).

63. Indeed, the ambiguous legislative history of the PSLRA led to considerable confusion, reflected most prominently in cases dealing with the heightened pleading requirement. *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2509 (2007) (noting divergence among lower courts regarding the meaning of the PSLRA's term "strong inference"); E. Powell Miller, *The Supreme Court's Decision in* Tellabs*: The Death Knell for Securities Fraud Class Actions? Not So Fast*, MICH. B.J., Oct. 2007, at 40, 40–42 (describing approaches of the different circuits to the heightened pleading standard and *Tellabs*'s resolution of the issue).

64. Congress independently determined that a plaintiff's recoverable loss was limited to the amount of his or her "actual damages." *See* 15 U.S.C. § 78bb(a) ("[N]o person . . . shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.").

65. *Id.* § 78u-4(b)(4) ("[T]he plaintiff shall have the burden of proving [loss causation]."). In contrast, the new causation provision under section 12 of the 1933 Act simply enables defendants to prove that their violations did not cause the plaintiffs' damages. *See id.* § 77*l*(b)

B. THE DURA *DECISION*

In 2005, the Supreme Court addressed the subject of loss causation in *Dura Pharmaceuticals, Inc. v. Broudo*.[67] Because the *Dura* facts offer challenges for causation analysis, it is worth considering them in some detail despite the limited nature of the Court's holding. The *Dura* litigation involved a series of developments with respect to two of Dura's major products: Albuterol Spiros ("AlSpiros") and Ceclor.[68] AlSpiros, a delivery device for asthma medication, was undergoing FDA review during the class period.[69] The plaintiffs claimed that Dura had issued several press releases falsely indicating satisfactory testing and development of AlSpiros.[70] At the same time, Dura was publicly claiming rising sales of Ceclor, an antibiotic.[71] In February 1998, Dura announced lower-than-expected earnings based on slow sales of Ceclor.[72] Dura later revealed that sales of Ceclor had been declining for some time.[73] Subsequently, in November 1998, Dura revealed that the FDA had failed to approve AlSpiros.[74] At the time of the announcements about Ceclor, Dura's stock price dropped dramatically.[75] Later, when Dura released the news about AlSpiros, its stock price dropped by 20% but then recovered.[76]

(allowing a defendant to prove "that any portion or all of the amount recoverable . . . represents other than the depreciation in value of the subject security resulting from [the fraud]").

66. The description of the loss causation requirement in the legislative history was consistent with the most liberal Ninth Circuit approach, which found it sufficient for the plaintiff to allege and prove merely that the defendant's fraud artificially inflated the price of the securities. In describing the loss causation requirement, the Senate Report stated:

> [T]he 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 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694. The House Conference Report contained the first sentence of this description, but not the second. H.R. REP. NO. 104-369, at 41 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.

67. Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005).

68. Broudo v. Dura Pharms., Inc., 339 F.3d 933, 935 (9th Cir. 2003), *rev'd*, 544 U.S. 336 (2005).

69. *Id.* at 935–36.

70. *Id.* at 935.

71. *Id.*

72. *Id.* at 936.

73. *Broudo*, 339 F.3d at 936.

74. *Id.*

75. *See* Patrick J. Coughlin et al., *What's Brewing in* Dura v. Broudo*? The Plaintiffs' Attorneys Review the Supreme Court's Opinion and Its Import for Securities-Fraud Litigation*, 37 LOY. U. CHI. L.J. 1, 13 (2005) ("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. The stock tumbled another 40% in the ensuing months." (footnote omitted)).

76. *Id.*

The *Dura* plaintiffs tried to establish loss causation by demonstrating that, at the time they purchased Dura stock, its price had been artificially inflated due to the defendant's misrepresentations.[77] Essentially, the plaintiffs argued that their damages consisted of overpayment at the time of the initial purchase. The Supreme Court granted certiorari on the narrow question of "[w]hether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price."[78]

The Supreme Court did little more than answer that question in the affirmative, stating that a plaintiff must plead and prove "a causal connection between the [defendant's] material misrepresentation and the [plaintiff's economic] loss."[79] The Court rejected the plaintiffs' claim that the purchase of Dura stock at an artificially inflated price was itself a legally cognizable injury. As the Court explained, an "'artificially inflated purchase price' is not itself a relevant economic loss."[80]

The Court offered several explanations for this conclusion. First, the Court reasoned that "as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value."[81] The Court also noted that a later sale might, but does not inevitably, lead to a loss, depending on whether the sale price reflects the truth.[82] Second, the Court explained that even if the plaintiff subsequently sells at a lower price, his loss may not have been caused by the defendant's fraud.[83] Rather, "that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price."[84]

The *Dura* opinion is perhaps most noteworthy for the limits of its analysis. Although the Court concluded that artificial price inflation is not an actionable harm, it did not explain what constitutes an appropriate economic loss, nor did it specify the nature of the required casual connection between the defendant's fraud and that loss. Commentators

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77. *Id.* at 10.

78. Brief for Petitioners at i, Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005) (No. 03-932), *available at* http://supreme.lp.findlaw.com/supreme_court/briefs/03-932/03-932.mer.pet.pdf.

79. *Dura*, 544 U.S. at 342.

80. *Id.* at 347.

81. *Id.* at 342.

82. *Id.*

83. *Id.* at 342–43.

84. *Dura*, 544 U.S. at 343.

have speculated as to whether *Dura* leaves room for plaintiffs to recover in the absence of a stock price drop, whether defendants may effectively block recovery by preemptively or simultaneously disclosing unrelated negative information, and how *Dura* applies to investors who have engaged in multiple transactions during the class period.[85] Lower court rulings have begun to address these questions.

C. *POST*-DURA *CASES*

Litigation over the causation requirement exploded in the wake of the *Dura* decision. As a practical matter, *Dura* established loss causation as the key gatekeeping mechanism for private securities fraud litigation. Challenges to a plaintiff's claim of loss causation are typically litigated in response to a motion to dismiss or at the class certification stage, and the courts have required a detailed showing of the relationship between the fraudulent statements and the subsequent stock price drop. This showing usually takes the form of an event study prepared by an expert witness.

Although *Dura* did not explicitly require a corrective disclosure,[86] the loss causation analysis in most cases has focused on both the identification of an adequate corrective disclosure and expert testimony tying that corrective disclosure to a drop in stock price. In addition, the courts have overwhelmingly required that the expert analysis separate the impact of other market- and firm-specific factors from the effect of disclosures that directly relate to the subject matter of the original fraud.[87] In other words, if multiple factors caused the stock price to drop, the expert testimony must demonstrate that the corrective disclosure is at least partially responsible for that drop.

The lower courts vary in their descriptions of the plaintiff's burden. The Fifth Circuit imposes perhaps the most demanding standard. In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, the Fifth Circuit held that the plaintiff has the burden of establishing loss causation in order to obtain class certification.[88] The court merged the conceptually distinct elements of loss

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85. *See, e.g.*, Merritt B. Fox, *After* Dura*: Causation in Fraud-on-the-Market Actions*, 31 J. CORP. L. 829, 846–62 (2006) (questioning the scope of *Dura* and identifying unresolved issues).

86. *See, e.g.*, Nursing Home Pension Fund v. Oracle Corp., No. C01-00988 MJJ, 2006 U.S. Dist. LEXIS 94470, at *35 (N.D. Cal. Dec. 20, 2006) ("[S]everal courts have recognized that *Dura* does not require a 10(b) plaintiff to identify a corrective disclosure in order to properly plead or prove loss causation.").

87. *See, e.g.*, *In re* Williams Sec. Litig., 496 F. Supp. 2d 1195, 1266 (N.D. Okla. 2007) (rejecting proffered expert testimony for failure "to differentiate between losses rooted in causes cognizable under loss causation doctrine, on one hand, and, on the other hand, losses attributable to industry-specific stresses, the meltdown in the telecommunications sector, and other negative developments unrelated to the alleged fraud"), *aff'd sub nom. In re* Williams Sec. Litig.—WCG Subclass, No. 07-5119, 2009 WL 388048 (10th Cir. Feb. 18, 2009).

88. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 269 (5th Cir. 2007).

causation and reliance, concluding that proof of loss causation, by a preponderance of the evidence,[89] is required to obtain the benefit of *Basic*'s presumption of reliance.[90] In support of this conclusion, the court cited the *in terrorem* effect of class certification[91] and noted that while the relationship between loss causation and reliance "is foremost an artifact of the common law's influence on 10b-5 actions, . . . it persists for good reason."[92] The court went on to establish a rigorous test for loss causation, requiring plaintiffs to show that it was more probable than not that the corrective disclosure specifically linked to the original fraud, and not unrelated negative statements, caused a "'significant amount'" of the stock price decline.[93]

Other courts have refused to go as far. A number of courts have explicitly rejected *Oscar*'s holding that loss causation analysis must be incorporated into the class certification decision.[94] Illustrative is *In re Micron Technologies, Inc. Securities Litigation*, in which the court stated that the Fifth Circuit's decision in *Oscar* was based on a misreading of *Basic*.[95] The court specifically found that the defendant has the burden, at the class certification stage, of "severing" the link between the misrepresentation and the drop in stock price, and that the defendant could not meet this burden by showing that other factors in addition to the fraud contributed to the

89. *Id.*

90. *Id.* at 265. *Oscar* was not the first decision to reinvigorate the reliance requirement. In *Hevesi v. Citigroup Inc.*, 366 F.3d 70 (2d Cir. 2004), the Second Circuit implied, albeit in dicta, that *Basic*'s presumption of reliance should be read narrowly. *Hevesi* involved a suit against research analysts, predicated on information uncovered by Eliot Spitzer's high-profile investigation. The *Hevesi* court stated that the extension of the *Basic* presumption from statements of fact by issuers to statements of opinion by research analysts was a "novel" and "significant" issue that was "'of fundamental importance to the development of the law of class actions.'" *Id.* at 80 (quoting *In re* Sumitomo Copper Litig., 262 F.3d 134, 140 (2d Cir. 2001)).

91. *Oscar*, 487 F.3d at 267.

92. *Id.* at 269 n.41.

93. *Id.* at 270 (quoting Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 666 (5th Cir. 2004)); *see also In re* Williams Sec. Litig.—WCG Subclass, No. 07-5119, 2009 WL 388048, at *5 (10th Cir. Feb. 18, 2009) ("The plaintiff bears the burden of showing that his losses were attributable to the revelation of the fraud and not the myriad other factors that affect a company's stock price."). Similarly, although at the summary judgment stage, the court in *In re Omnicom Group, Inc. Securities Litigation* granted the defendants' motion for summary judgment on the basis that the plaintiffs' expert had disaggregated only some but not all of the allegedly confounding factors. *In re* Omnicom Group, Inc. Sec. Litig., 541 F. Supp. 2d 546, 554 (S.D.N.Y. 2008).

94. *See, e.g.*, *In re* Nature's Sunshine Prods. Inc. Sec. Litig., 251 F.R.D. 656, 665 (D. Utah 2008) ("Other courts have refused to follow *Oscar* . . . ."); Darquea v. Jarden Corp., No. 06 Civ. 722(CLB), 2008 WL 622811, at *4 (S.D.N.Y. Mar. 6, 2008) (explaining that *Oscar*'s standard "is limited to the Fifth Circuit"); Wagner v. Barrick Gold Corp., 251 F.R.D. 112, 118 (S.D.N.Y. 2008) (explaining disagreement among lower courts on "'the issue of whether loss causation must be established to trigger the fraud on the market presumption'" (quoting the defendants' memorandum)).

95. *In re* Micron Techs., Inc. Sec. Litig., 247 F.R.D. 627, 634 (D. Idaho 2007) ("[*Oscar*'s] reading of *Basic* ignores a crucial footnote.").

decline in the stock price.[96] Other courts have agreed, reasoning that, so long as the pleadings raise disputed issues of fact, causation is a question properly left for the jury.[97]

D. STONERIDGE

Oscar reasserted a link between loss causation and reliance that earlier courts had disavowed. With this link, the Fifth Circuit extended the gatekeeping role of the loss causation requirement to cut back on the scope of *Basic*. Reliance too, it seemed, could narrow the scope of private securities litigation. The Supreme Court's 2008 decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[98] took this approach further. On its face, *Stoneridge* did not implicate causation or reliance. The question presented to the Supreme Court was the appropriate scope of "scheme liability."[99] Scheme liability is a pleading tool that plaintiffs developed in an effort to circumvent the Court's 1994 holding in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[100] that section 10(b) does not provide a private right of action against those who aid and abet securities fraud.[101] The court of appeals in *Stoneridge*, without discussing reliance or causation, held that *Central Bank* limited private liability to defendants who actually make fraudulent statements and that, to the extent the plaintiff's claims of scheme

96. *Id.* at 634–35; *see also* Freeland v. Iridium World Commc'ns, Ltd., 545 F. Supp. 2d 59, 80 (D.D.C. 2008) ("Loss causation is an affirmative defense and the risk of nonpersuasion is on [the defendant], not Plaintiffs.").

97. *See, e.g.*, *Freeland*, 545 F. Supp. 2d at 80 (holding that, where factual issues remained, loss causation determination was properly left for the jury); *see also* Exxon Co., U.S.A. v. Sofec, Inc., 517 U.S. 830, 840–41 (1996) (stating that proximate and superseding cause are usually issues for the jury); EP Medsystems, Inc. v. EchoCath, Inc., 235 F.3d 865, 884 (3d Cir. 2000) (stating that loss causation is a fact-intensive inquiry best resolved by the trier of fact).

98. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).

99. *See id.* at 770–72 (addressing the plaintiffs' "scheme liability" argument).

100. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177 (1994).

101. The actual question presented in *Stoneridge* was:

> Whether this Court's decision in *Central Bank* forecloses claims under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) and (c) where Respondents engaged in their own deceptive conduct in transactions with a public corporation for the purpose and effect of creating a false appearance of material fact that enabled the publication of artificially inflated financial statements by the public corporation, but where Respondents themselves made no public statements concerning those transactions.

Brief for Petitioner at i, *Stoneridge*, 128 S. Ct. 761 (No. 06-43) (citations omitted), *available at* http://www.oyez.org/cases/2000-2009/2007/2007_06_43/briefs/petitioner/Brief%20for%20Petitioner%20Stoneridge%20Investment%20Partners,%20LLC.pdf.

liability attempted to extend liability further, they constituted no more than claims of aiding and abetting.[102]

At the Supreme Court, the defendants, aided by the Solicitor General,[103] argued that the reliance requirement precluded the plaintiffs' claim. They reasoned that because the third-party defendants had failed to make any statements directly to the investing public, investors could not claim to have relied on the defendants' conduct, even if such conduct was fraudulent.[104] The Supreme Court accepted this argument, thereby endorsing a conscious-awareness version of reliance that is directly in tension with its holding in *Basic*.[105]

The Supreme Court's rejection of scheme liability was not surprising in light of its repeated and express hostility towards private securities fraud litigation, although the statutory text does not support its narrow reading of reliance.[106] More surprising was its disavowal of the analogy to common law tort in order to reach this result. Despite its explicit reference to common law fraud in *Dura* just two and a half years earlier, the Court dismissively explained that not all common law fraud violates section 10(b).[107] While that statement is certainly true, it does not provide a reason for rejecting common law interpretive principles in determining the scope of an element derived from the common law.[108] At the same time, the Supreme Court

102. *See* Stoneridge Inv. Partners, LLS v. Scientific-Atlanta, Inc. (*In re* Charter Commc'ns, Inc., Sec. Litig.), 443 F.3d 987, 992 (8th Cir. 2006), *aff'd sub nom.* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).

103. *See* Brief for the United States as Amicus Curiae Supporting Affirmance at 18–25, *Stoneridge*, 128 S. Ct. 761 (No. 06-43) (arguing that there was an absence of reliance because the defendants' conduct, although deceptive, only misled the issuer's accountant and not the investing public). Interestingly, the government's position on the *Stoneridge* case was the subject of an intense political battle. Originally, the SEC had asked the Solicitor General to file an amicus brief on behalf of the plaintiffs, defending scheme liability. The White House intervened and objected, directing the Solicitor General instead to file a brief on behalf of the defendants, which he did. *See* Press Release, Senator Chris Dodd, Chairman Dodd Expresses Disappointment with Administration Decision to Reject SEC Position in *Stoneridge* Case (Aug. 16, 2007), *available at* http://dodd.senate.gov/index.php?q=node/4011 (describing the political battle).

104. Brief for Respondents at 17–21, *Stoneridge*, 128 S. Ct. 761 (No. 06-43), *available at* http://www.oyez.org/cases/2000-2009/2007/2007_06_43/briefs/respondent/Brief%20for%20Respondents%20Scientific-Atlanta,%20Inc.%20and%20Motorola,%20Inc..pdf.

105. *See Stoneridge*, 128 S. Ct. at 776 (Stevens, J., dissenting).

106. The text of section 10(b) expressly imposes liability on those who "directly or indirectly" engage in fraudulent or deceptive practices. 15 U.S.C. § 78j(b) (2000).

107. *Stoneridge*, 128 S. Ct. at 771 ("Section 10(b) does not incorporate common-law fraud into federal law.").

108. Concededly, as Justice Stevens observed, it would have been more difficult for the Court to justify its decision in light of authority suggesting that the plaintiff's reliance allegations satisfied the common law standard. Justice Stevens explained:

> The *Restatement (Second) of Torts* § 533 provides that "[t]he maker of a fraudulent misrepresentation is subject to liability . . . if the misrepresentation, although not made directly to the other, is made to a third person and the maker intends or has

seemingly confirmed the relationship between reliance and causation forged by *Oscar*. As Justice Kennedy, writing for the Court, stated: "[R]eliance is tied to causation, leading to the inquiry whether [the defendants'] acts were immediate or remote to the injury."[109] The implications of this link in light of the tension between *Basic* and *Stoneridge* remain unclear.

III. TORT LAW FOUNDATIONS OF THE CAUSATION REQUIREMENT

The extent to which federal securities law should incorporate tort law principles is a difficult question. The Supreme Court has spoken to the issue on few occasions and has never engaged in a detailed analysis. In earlier cases, such as *Basic*, the Court warned against applying common law to restrict unduly the scope of the federal statutory claim. In *Stoneridge*, the Court took the opposite view, expressing concern that the common law would improperly expand the scope of liability. In neither of these cases, however, did the Supreme Court carefully examine the applicable common law principles. This Article now turns to those principles because, before deciding whether to incorporate common law principles, it is valuable to understand the precise scope of the common law rules.

A. The Causation Requirement in Tort Law

Although commentators have widely recognized that causation inquiries raise difficult philosophical questions[110]—most of which are beyond the scope of this Article—legal doctrine continues to rely heavily on causation analysis in a variety of contexts.[111] As used in securities litigation, the causation requirement has its roots in tort law, specifically the law of

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> reason to expect that its terms will be repeated or its substance communicated to the other."

Id. at 777 (Stevens, J., dissenting) (alterations in original) (internal citation omitted) (quoting RESTATEMENT (SECOND) OF TORTS § 533 (1977)).

109. *Id.* at 770 (majority opinion). To the extent reliance is analogous to but-for causation, it is worth noting that the requirement that the defendants' acts be immediate to the injury is not based upon common law tort principles. *See infra* Part III.

110. *See, e.g.*, HERBERT A. SIMON, MODELS OF MAN 11 (1957) (describing "the generally unsavory epistemological status of the notion of causality"); Christopher Bernert, *The Career of Causal Analysis in American Sociology*, 34 BRIT. J. SOC. 230, 230 (1983) ("Few terms have suffered either the infamy or the taken-for-grantedness of 'cause.'"); John DiNardo, *Interesting Questions in* Freakonomics, 45 J. ECON. LITERATURE 973, 978 (2007) ("[E]xcept for the very simplest phenomenon, it is rarely clear what constitutes a good answer to . . . a [causation] question.").

111. *See, e.g.*, Allen v. Wright, 468 U.S. 737, 753 n.19 (1984) (identifying causation as a required component of Article III standing analysis); Associated Gen. Contractors of Cal., Inc. v. Cal. State Council of Carpenters, 459 U.S. 519, 535–37 (1983) (analyzing proximate cause under the Clayton Act); Mt. Healthy City Sch. Dist. Bd. of Educ. v. Doyle, 429 U.S. 274, 285–87 (1977) (recognizing a but-for-causation requirement in a constitutional-tort case); Arthur Leavens, *A Causation Approach to Criminal Omissions*, 76 CAL. L. REV. 547, 562–72 (1988) (discussing the roles of but-for and proximate causation in criminal law).

negligence.[112] Liability for negligence requires wrongful conduct, causation, and harm. Causation establishes a connection between the defendant's conduct and the plaintiff's harm.[113] Tort law has used a variety of terms to describe various components of the causation inquiry, including "but-for cause," "cause in fact," "proximate cause," "legal cause," and more.[114] The terms are generally meant to distinguish between factual and legal causation, although the line between the two is often blurred.[115]

Factual causation, or cause in fact, is often equated with but-for causation. In describing factual causation, Prosser and Keeton explained: "The defendant's conduct is a cause of the event if the event would not have occurred but for that conduct; conversely, the defendant's conduct is not a cause of the event, if the event would have occurred without it."[116] The *Restatement (Third) of Torts* ("*Third Restatement*") uses similar terminology to describe factual causation in historical terms, but it omits the counterfactual[117]: "Conduct is a factual cause of harm when the harm would not have occurred absent the conduct."[118]

Courts generally found factual causation necessary but not sufficient to impose liability for a defendant's wrongful conduct. As a result, they developed the requirement of legal, or proximate, cause. The rationale for

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112. *Cf.* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 33(b) (Proposed Final Draft No. 1, 2005) ("An actor who intentionally or recklessly causes physical harm is subject to liability for a broader range of harms than . . . if [he had] only act[ed] negligently."); Tony Honoré, *Necessary and Sufficient Conditions in Tort Law*, *in* PHILOSOPHICAL FOUNDATIONS OF TORT LAW 363, 370 (David G. Owen ed., 1995) ("[I]n cases of strict liability, where the wrongfulness of the defendant's conduct is not in issue, there is no occasion to trace a causal path from wrongfulness to the plaintiff's harm."). *But see* RESTATEMENT (SECOND) OF TORTS § 431 cmt. e (1965) (stating that the description of what constitutes legal cause in negligence cases is equally applicable in cases of intentional torts and strict liability); *cf.* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 33(c) (Proposed Final Draft No. 1, 2005) ("[A]n actor who intentionally or recklessly causes physical harm is not subject to liability for harm the risk of which was not increased by the actor's intentional or reckless conduct.").

113. The requirement that the defendant's wrongful actions produce harm is fundamental to tort law. As the Seventh Circuit has explained, "punishing a person for an act that does no harm is not needed to deter harmful acts." United States v. Johnson, 380 F.3d 1013, 1016 (7th Cir. 2004). More precisely, the injury requirement serves to distinguish tort law from criminal law. John C.P. Goldberg & Benjamin C. Zipursky, *Unrealized Torts*, 88 VA. L. REV. 1625, 1646 (2002).

114. *See* Guido Calabresi, *Concerning Cause and the Law of Torts: An Essay for Harry Kalven, Jr.*, 43 U. CHI. L. REV. 69, 71 (1975) (describing the concept of a "causal link").

115. *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 26 reporters' note, cmt. a (Proposed Final Draft No. 1, 2005).

116. KEETON ET AL., *supra* note 23, § 41, at 266.

117. For an explanation of the use of counterfactuals in analyzing factual causation, see Robert N. Strassfeld, *If . . . : Counterfactuals in the Law*, 60 GEO. WASH. L. REV. 339, 345–46 (1992).

118. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 26 (Proposed Final Draft No.1, 2005); *see also* H.L.A. HART & TONY HONORÉ, CAUSATION IN THE LAW 109–29 (2d ed. 1985) (formulating a description of but-for cause in terms of a "condition *sine qua non*").

the proximate cause requirement is to limit the harms for which the defendant is legally responsible based on some conception of the appropriate scope of accountability.[119] The *Third Restatement* states that "the term 'proximate cause' is a poor one to describe limits on the scope of liability,"[120] and instead substitutes a concept of legal responsibility.[121]

As Tony Honoré explains, the plaintiff must "show that the element that makes the conduct wrongful or creates the undue risk was relevant to the harmful outcome for which the law provides a remedy."[122] The *Third Restatement* incorporates this concept, limiting an actor's liability to "those . . . harms that result from the risks that made the actor's conduct tortious."[123] The comments term this the "risk standard."[124] Thus, the *Restatement* requires a precise specification of the nature of the plaintiff's harm. As it explains, although a defendant might be negligent in entrusting a loaded shotgun to a nine-year-old child, if that child drops the shotgun on someone's toe, rather than accidentally shooting them, the victim's broken toe, albeit a harm, is not within the scope of the risk created by the defendant's negligent conduct.[125] The *Restatement* explains that this standard eliminates the need to conduct an analysis of proximate cause, because it offers an alternative mechanism to limit the harms for which the defendant is legally responsible.[126]

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119. Many commentators therefore argue that proximate cause is not about causation at all but rather involves an analysis of the policy considerations affecting the scope of the defendant's legal responsibility for the plaintiff's injury. *See* Anna Burdeshaw Fretwell, Note, *Clearing the Air: An Argument for a Federal Cause of Action to Provide an Adequate Remedy for Smokers Injured by Tobacco Companies*, 31 GA. L. REV. 929, 943 n.72 (1997). These policy considerations may make the proximate cause inquiry appear unprincipled. Prosser and Keeton observe that:

> "Proximate cause," in short, has been an extraordinarily changeable concept. "Having no integrated meaning of its own, its chameleon quality permits it to be substituted for any one of the elements of a negligence case when decision on that element becomes difficult. . . . No other formula . . . so nearly does the work of Aladdin's lamp."

KEETON ET AL., *supra* note 23, § 42, at 276 (alterations in original) (quoting Leon Green, *Proximate Cause in Texas Negligence Law*, 28 TEX. L. REV. 471, 471–72 (1950)).

120. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 29 cmt. b (Proposed Final Draft No. 1, 2005).

121. *See id.* § 29. This concept is consistent with Prosser and Keeton's description of proximate cause. *See* KEETON ET AL., *supra* note 23, § 42, at 272–73 ("Once it is established that the defendant's conduct has in fact been one of the causes of the plaintiff's injury, there remains the question whether the defendant should be legally responsible for the injury." (footnote omitted)).

122. Honoré, *supra* note 112, at 368.

123. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 29 (Proposed Final Draft No. 1, 2005).

124. *Id.* § 29 cmt. d.

125. *Id.* § 29 cmt. d, illus. 3.

126. *See id.* § 29 cmt. h (explaining that section 29 reverses the position taken by section 281 of the *Second Restatement*, which made a person "who threatened harm to a legally

Common law fraud cases employ a somewhat different causation analysis.[127] In cases involving fraud, the courts' inquiry into causation is usually satisfied by proof of reliance, which courts view as establishing factual causation. Courts rarely consider proximate cause extensively.[128] As David Robertson explains: "The rule of legal (proximate) cause (scope of responsibility) for intentional torts sweeps very broadly, almost to the full reach of factual causation."[129] In particular, the requirement in negligence cases that the plaintiff's harm be an expectable or foreseeable consequence of the defendant's actions does not apply to intentional torts.[130] Although the *Third Restatement* does incorporate the negligence requirement that the defendant's tortious conduct increase the risk of harm,[131] in practice, few cases even consider something akin to a loss causation analysis.[132]

There are several reasons to treat causation differently in intentional tort cases. First, in most intentional tort cases, the defendant's wrongful conduct is closely linked—temporally and conceptually—to the plaintiff's harm. Cases involving competing or multiple causal factors are relatively rare. Second, the required state of mind associated with an intentional tort makes it easier to view the defendant as morally blameworthy, leading courts

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cognizable interest of another liable for all harm to the other, regardless of whether the harm was different from the harms whose risk made the actor's conduct tortious").

127. Arguably, the causation requirement is further minimized in the criminal context. For example, Michael Moore notes that accomplice liability extends well beyond cases in which the accomplice can be said to have caused the harm, and explains the resulting scope of liability largely in terms of moral blameworthiness. *See generally* Michael S. Moore, *Causing, Aiding, and the Superfluity of Accomplice Liability*, 156 U. PA. L. REV. 395 (2007). Significantly, although a complete analysis of causation in criminal cases is beyond the scope of this Article, it is noteworthy that lower courts have cited *Dura* in requiring proof of loss causation for purposes of the damage calculation required by the criminal-sentencing guidelines. *See, e.g.*, United States v. Olis, 429 F.3d 540, 546 (5th Cir. 2005) (applying methods of measuring civil damages as a "backdrop" to determining criminal responsibility). To the extent that causation analysis is different under the criminal law, this approach may be problematic. *See* Samuel W. Buell, *Reforming Punishment of Financial Reporting Fraud*, 28 CARDOZO L. REV. 1611, 1628–38 (2007) (discussing the application of criminal-sentencing guidelines to cases involving accounting fraud at large publicly traded companies).

128. *See, e.g.*, Seidel v. Greenberg, 260 A.2d 863, 873 (N.J. Super. Ct. Law Div. 1969) ("[M]any of the limitations upon liability that are subsumed under the doctrine of 'proximate cause' . . . do not apply to intentional torts." (quoting Tate v. Canonica, 5 Cal. Rptr. 28, 33 (Dist. Ct. App. 1960)) (internal quotation marks omitted)).

129. David W. Robertson, *The Common Sense of Cause in Fact*, 75 TEX. L. REV. 1765, 1773 n.30 (1997).

130. *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 33(a) (Proposed Final Draft No. 1, 2005) ("An actor who intentionally causes physical harm is subject to liability for that harm even if it was unlikely to occur."); RESTATEMENT (SECOND) OF TORTS § 435A (1965) ("A person who commits a tort against another for the purpose of causing a particular harm . . . is liable for such harm if it results, whether or not it is expectable . . . .").

131. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 33 cmt. f (Proposed Final Draft No. 1, 2005).

132. *See id.* § 33 reporters' note, cmt. f.

to express less concern about the scope of harm for which he or she is held accountable.[133] Finally, imposing liability for intentional torts does not generally pose a risk of inefficient overdeterrence.

The limited scope of the causation requirement in common law fraud does not mean that courts are wrong to impose a more rigorous requirement in federal securities fraud. Indeed, there may be a number of policy justifications for applying a stricter causation requirement under Rule 10b-5. Nonetheless, courts should recognize in imposing any such requirement that it is being employed despite—not because of—the common law origins of the federal securities fraud claim. Part V of this Article considers whether courts should apply the more rigorous common law negligence principles to federal securities fraud. Before addressing that question, however, it is important to consider in more detail how the common law has addressed problems of complex causation and, in turn, the relationship between causation and harm.

B. Tort Law Approaches to Causal Complexity

Cases involving multiple causal factors complicate the analysis of causation.[134] Tort law recognizes the possibility of multiple tortfeasors, who can act either in concert or individually to cause a single harm. Complexity arises in situations in which the particular wrongdoer cannot be identified with certainty, as well as where the contributing causes of the plaintiff's harm are different in kind, are separated in time or space, involve a mixture of wrongful and innocent actions, or include nonhuman elements such as forces of nature or acts of God. As the comments to section 34 of the *Third Restatement* recognize, early tort law was premised on a formalistic approach to causation based on the belief that cause could be determined through a "neutral, scientific inquiry."[135] This approach has become outdated.[136]

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133. *See, e.g.*, Russell D. Covey, *The Unbearable Lightness of* Batson*: Mixed Motives and Discrimination in Jury Selection*, 66 MD. L. REV. 279, 335–36 (2007) ("In intentional tort cases, the injury combined with the intent to cause it establish a sufficient equitable basis for liability as long as the actor's conduct might be said to have contributed to the risk."); Meredith J. Duncan, *Criminal Malpractice: A Lawyer's Holiday*, 37 GA. L. REV. 1251, 1279 n.133 (2003) ("Because of the state of mind required to prove that a defendant is liable for an intentional tort, any intervening event, such as another person's negligence, typically does not break the chain of causation between the defendant's intentional act and any resulting harm . . . .").

134. There is an extensive literature on the role of causation in tort law and, in particular, on cases involving multiple and overdetermined causation. The textual discussion in this Section cannot hope to consider all the nuances of that literature. For a sample, see generally HART & HONORÉ, *supra* note 118; Goldberg & Zipursky, *supra* note 113; Michael D. Green, *The Intersection of Factual Causation and Damages*, 55 DEPAUL L. REV. 671 (2006); *Symposium on Causation in the Law of Torts*, 63 CHI.-KENT L. REV. 397 (1987); Richard W. Wright, *Causation in Tort Law*, 73 CAL. L. REV. 1735 (1985).

135. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 34 cmt. a (Proposed Final Draft No. 1, 2005).

136. *Id.*

Modern cases recognize the inevitability of multiple causal factors and the impracticality of attempting to identify a single factual or legal cause of a plaintiff's harm.

Modern tort law acknowledges "that there are always multiple causes of an outcome and that the existence of intervening causes does not ordinarily elide a prior actor's liability."[137] Although the existence of multiple causes may reduce the defendant's liability to some portion of the plaintiff's harm, that issue is addressed through the allocation of damages, not by relieving the defendant of liability. More importantly, as discussed below, even when the presence of multiple causal factors makes it impossible to identify the defendant's tortious conduct as a but-for cause of the plaintiff's harm, common law courts have nonetheless imposed liability.

Multiple causal factors may operate, in the tort context, in several ways. In some cases, tortious conduct causes harm in combination with another nontortious factor. An early example of this type of multiple causation was the series of "two fires" cases,[138] in which, at the same time that a negligently set fire approached the plaintiff's property, another fire (typically of non-negligent or unknown origin) also approached.[139] The combined effect of both fires destroyed the property, but because each fire was sufficient to destroy the property independently, neither could be identified as a but-for cause of the harm.[140]

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137. *Id.*

138. The commonly cited "two fires" cases are *Kingston v. Chicago & Northwestern Railway Co.*, 211 N.W. 913 (Wis. 1927), *Anderson v. Minneapolis, St. Paul & Sault Ste. Marie Railway Co.*, 179 N.W. 45 (Minn. 1920), and *Cook v. Minneapolis, St. Paul & Sault Ste. Marie Railway Co.*, 74 N.W. 561 (Wis. 1898).

139. For some reason, courts did not appear to have difficulty finding but-for causation when the two fires were both of negligent origin. *See, e.g.*, Seckerson v. Sinclair, 140 N.W. 239, 244 (N.D. 1913) ("[W]hen the wrong of two persons jointly contributes to the injury, both of such persons are liable."). There was greater disagreement in the old cases about both the appropriate approach and the correct result when one fire was of non-negligent origin. *Compare Anderson*, 179 N.W. at 49 (applying the substantial-factor test to impose liability despite the absence of but-for causation), *with Cook*, 74 N.W. at 566 ("[W]here a cause set in motion by negligence, reaches to the result complained of in a line of responsible causation, and another cause, having no responsible origin, reaches it at the same time, so that what then takes place would happen as the effect of either cause, entirely regardless of the other, then the consequence cannot be said, with any degree of certainty, to relate to negligence as its antecedent; requisite intelligent causation necessary to legal liability is wanting, leaving no ground, in reason or in law, for it to rest upon.").

140. *See, e.g.*, Robert J. Peaslee, *Multiple Causation and Damage*, 47 HARV. L. REV. 1127, 1130 (1934). Peaslee notes:

> [W]here one of the causes is innocent and the other culpable in origin, as of the two fires uniting before reaching and burning the plaintiff's house, must the negligent actor pay the whole loss, or is he responsible for none of it? On the one hand is sufficient wrongful causation of a physical result, and on the other,

A modern example is litigation over lung cancer associated with asbestos exposure. Many plaintiffs who were exposed to asbestos and subsequently developed lung cancer also smoked cigarettes. While asbestos exposure is associated with a statistically significant increase in the likelihood of developing lung cancer, so is cigarette smoking.[141] Therefore, as a practical matter, it is difficult to establish that the asbestos exposure, and not the cigarette smoking, is responsible for a particular victim's disease.[142] The issue is further complicated by scientific studies indicating that asbestos and cigarette smoking tend to work synergistically, multiplying the risk beyond that attributable to either factor alone.[143]

Sometimes the problem is not that multiple causal factors combine, but that the plaintiff cannot isolate which of the multiple causal factors operating independently but in a similar fashion is responsible for the harm. An example is the classic torts case of *Summers v. Tice*.[144] Tice was injured when two hunters negligently fired their guns, but it was impossible to establish which hunter hit him and, thus, which hunter's negligence was a but-for cause of his injuries.[145] A modern example is *Sindell v. Abbott Laboratories*.[146] The plaintiffs were injured by the drug DES that one of the defendants manufactured, but the plaintiffs could not establish which defendant produced the product that resulted in their specific injuries.[147]

> inevitable loss not increased by the defendant's wrong. Recovery would make the plaintiff better off than he would have been if the defendant had done no wrong.

Id.

141. *See* Gerald W. Boston, *A Mass-Exposure Model of Toxic Causation: The Content of Scientific Proof and the Regulatory Experience*, 18 COLUM. J. ENVTL. L. 181, 299–301 (1993) (describing the challenge presented by combined asbestos exposure and cigarette smoking).

142. *See, e.g.*, Brian M. DiMasi, Comment, *The Threshold Level of Proof of Asbestos Causation: The "Frequency, Regularity and Proximity Test" and a Modified* Summers v. Tice *Theory of Burden-Shifting*, 24 CAP. U. L. REV. 735, 739 (1995) (explaining that many asbestos victims who smoke "are unable to prove the prima facie element of legal causation and are defeated by defendants' motions for summary judgment").

143. Deirdre A. McDonnell, Comment, *Increased Risk of Disease Damages: Proportional Recovery as an Alternative to the All or Nothing System Exemplified by Asbestos Cases*, 24 B.C. ENVTL. AFF. L. REV. 623, 639 (1997) ("[T]he combination of asbestos exposure and cigarette smoking produces a synergistic effect that creates an extremely high chance of lung cancer.").

144. Summers v. Tice, 199 P.2d 1 (Cal. 1948).

145. *See id.* at 1–3.

146. Sindell v. Abbott Labs., 607 P.2d 924 (Cal. 1980).

147. *Id.* at 936. Similarly, in *Borel v. Fibreboard Paper Products Corp.*, the plaintiff was exposed, over a period of time, to asbestos manufactured by several defendants. Borel v. Fibreboard Paper Prods. Corp., 493 F.2d 1076, 1094 (5th Cir. 1973). Because the effects of asbestos exposure are cumulative and take years to develop, the court found that "it is impossible, as a practical matter, to determine with absolute certainty which particular exposure to asbestos dust resulted in injury to Borel." *Id.* Unlike *Summers* and *Sindell*, it was possible that, as a factual matter, all of the asbestos exposures had contributed to Borel's injury, but like those cases, it was impossible for the court to determine factual causation with certainty.

To address these problems, the first two *Restatements of Torts* employed the "substantial-factor" test. Under this test, a defendant's conduct was considered a cause of the plaintiff's harm if such conduct was a substantial factor in bringing about the harm.[148] So long as the defendant's conduct was a substantial factor, the presence of other contributing factors did not relieve the defendant of liability. The *Restatement (Second) of Torts* noted: "If two forces are actively operating, one because of the actor's negligence, the other not because of any misconduct on his part, and each of itself is sufficient to bring about harm to another, the actor's negligence may be found to be a substantial factor in bringing it about."[149]

A weakness of the substantial-factor test was that it required factfinders to determine which contributing causes were legally significant, an approach that confuses the concepts of factual and legal causation. The *Third Restatement* seeks to cabin the factfinder's discretion and prevent efforts to identify scientifically the "right" cause.[150] Under the *Third Restatement*, tortious conduct must be a factual cause of the harm, which means that "the harm would not have occurred absent the conduct."[151] The *Third Restatement* deals with duplicative causation by providing that multiple sufficient causal factors are each "regarded as a factual cause of the harm."[152] As the Reporters' Notes to the *Third Restatement* explain: "There is near-universal recognition of the inappropriateness of the but-for standard for factual causation when multiple sufficient causes exist."[153] Put differently, tort law imposes liability in cases of overdetermined causation "for the practical

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148. RESTATEMENT (SECOND) OF TORTS § 431 (1965); *see also id.* § 433 (setting forth factors to consider in determining whether the defendant's conduct was a substantial factor in bringing about the plaintiff's harm).

149. *Id.* § 432(2).

150. *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 26 reporters' note, cmt. c (Proposed Final Draft No. 1, 2005). This note states:

> [C]ommon understanding and usage often look for a single "responsible cause" and attribute an event to that unusual or extraordinary action or conduct. . . . This common usage may lead juries, lawyers, and courts astray in a case where two or more relevant events may have been actual causes of plaintiff's harm.

Id.

151. *Id.* § 26.

152. *Id.* § 27. This approach borrows heavily from the Necessary Element of a Sufficient Set ("NESS") test advocated by Richard Wright. The NESS test "states that a particular condition was a cause of a specific consequence if and only if it was a necessary element of a set of antecedent actual conditions that was sufficient for the occurrence of the consequence." Wright, *supra* note 134, at 1774. Wright grounded his test in a normative conception of the defendant's responsibility. *See id.* at 1827 (describing the connection between the defendant's legal responsibility and principles of corrective justice). The NESS test is particularly useful in solving the counterfactual problem posed by but-for causation—that is, teasing out the consequences that would have occurred in the absence of the defendant's wrongful conduct.

153. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 27 reporters' note, cmt. a (Proposed Final Draft No. 1, 2005).

reason that tortious activity that produces harm would go unsanctioned otherwise."[154]

Rather than allocating responsibility through causation, the *Restatements* address the contributions of multiple causal factors, where appropriate, by apportioning damages. In some cases, it is possible to untangle the harms associated with multiple causal factors—allocating responsibility to each defendant for his or her proportionate share of the harm.[155] In cases involving a single indivisible harm, this approach is impractical,[156] and courts have devised alternatives.[157] Either approach, however, requires a preexisting theory that explains why it is reasonable to attribute a specific share of responsibility to the defendant. In a smoking/asbestos case, for example, one could argue that the asbestos manufacturers' responsibility should be reduced because of the smoking plaintiff's comparative fault.[158] For this reason, apportionment of damages is more commonly applied in the negligence context, in which the law seeks to achieve an efficient level of deterrence by precisely tailoring liability. More importantly, as indicated above, these efforts are directed to the allocation of damages—courts have generally rejected the argument that these difficulties should preclude recovery.[159]

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154. United States v. Johnson, 380 F.3d 1013, 1016 (7th Cir. 2004).

155. The *Second Restatement* provides:

> § 433A. Apportionment of Harm to Causes
>
> (1) Damages for harm are to be apportioned among two or more causes where
>
> (a) there are distinct harms, or
>
> (b) there is a reasonable basis for determining the contribution of each cause to a single harm.
>
> (2) Damages for any other harm cannot be apportioned among two or more causes.

RESTATEMENT (SECOND) OF TORTS § 433A (1965). Allocation of damages among multiple tortfeasors is more complex under the *Third Restatement. See* RESTATEMENT (THIRD) OF TORTS: APPORTIONMENT OF LIAB. § 8 (2000) (allocating responsibility according to the "nature of [each] person's risk-creating conduct" and "the strength of the causal connection between [such] conduct and the harm").

156. *See, e.g.*, Martin v. Owens-Corning Fiberglas Corp., 528 A.2d 947, 950 (Pa. 1987) (citing expert testimony explaining that it was impossible to separate out the effects of asbestos exposure and smoking on the plaintiff's pulmonary disability).

157. *See, e.g.*, Sindell v. Abbott Labs., 607 P.2d 924, 937–38 (Cal. 1980) (imposing liability based on market share).

158. *See, e.g.*, Brisboy v. Fibreboard Corp., 418 N.W.2d 650, 654–57 (Mich. 1988) (holding that an asbestos manufacturer's liability for the plaintiff's lung cancer should be reduced to reflect the plaintiff's comparative fault for smoking cigarettes).

159. *See* RESTATEMENT (THIRD) OF TORTS: APPORTIONMENT OF LIAB. § C18 (2000) ("If the independent tortious conduct of two or more persons is a legal cause of an indivisible injury, each person is jointly and severally liable for the recoverable damages caused by the tortious conduct, subject to the reallocation provision of § C21."). As stated by Dean Prosser and Dean Keeton:

Causation analysis is further complicated when the multiple causal factors operate sequentially rather than simultaneously. Does the intervention of subsequent tortious (or innocent) conduct relieve an initial tortfeasor of responsibility? Does harm inflicted by an initial wrongdoer preempt a causal role for subsequent conduct? In many cases, the time period between the wrongful conduct and the injury is relatively short, but as the temporal and spatial separation between the two increases, it begins to seem less reasonable to impose liability. One way to avoid imposing liability is by identifying an alternative cause of the harm.[160]

Courts have used terms such as "preemptive cause," "superseding cause," and "intervening cause" to address the sequential operation of multiple causal factors. Under the common law, not all intervening events relieve a tortfeasor of liability. Some courts use the term "superseding cause" to identify an intervening event that is sufficient to break the causal chain.[161] As the Minnesota Supreme Court explained:

> For an intervening cause to be considered a superseding cause, the intervening cause must satisfy four elements: 1) its harmful effects must have occurred after the original negligence; 2) it must not have been brought about by the original negligence; 3) it must have actively worked to bring about a result which would not otherwise have followed from the original negligence; and 4) it must not have been reasonably foreseeable by the original wrongdoer.[162]

Even under this strict analysis, applying the doctrine of superseding cause in tort law is problematic from a policy perspective. Consider Richard Wright's example of the defendant who shoots a person just as he is about to drink a cup of poisoned tea—or, even better, after the victim drinks the tea, but before the poison takes effect.[163] Wright argues that the defendant's

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> Certain results, by their very nature, are obviously incapable of any reasonable or practical division. . . . No ingenuity can suggest anything more than a purely arbitrary apportionment of such harm. Where two or more causes combine to produce such a single result, incapable of any reasonable division, each may be a substantial factor in bringing about the loss, and if so, each is charged with all of it.

KEETON ET AL., *supra* note 23, § 52, at 347.

160. *See* Michael S. Moore, *The Metaphysics of Causal Intervention*, 88 CAL. L. REV. 827, 875 (2000) ("[C]ausation peters out over time, much as the ripples from a stone dropped in a pond diminish as they travel outward.").

161. *See, e.g.*, Harrington v. Regina Med. Ctr., No. A03-1566, 2004 Minn. App. LEXIS 913, at *9 (Minn. Ct. App. July 26, 2004).

162. Canada *ex rel.* Landy v. McCarthy, 567 N.W.2d 496, 507 (Minn. 1997).

163. *See, e.g.*, Richard W. Wright, *Once More into the Bramble Bush: Duty, Causal Contribution, and the Extent of Legal Responsibility*, 54 VAND. L. REV. 1071, 1112–14 (2001) (describing some variations of the poisoned-tea example to distinguish duplicative from preemptive causation).

shot was a preemptive cause of the victim's death.[164] The poisoner has no more caused the victim's death than a shooter who comes along afterwards and pumps bullets into the victim's lifeless body.[165] The poisoner's actions, however, create a difficulty in establishing but-for causation with respect to the shooter. Because the victim would have died irrespective of the shooter's actions, one can argue that the shooting was not a but-for cause of the death. The result is an untidy situation involving a dead victim and two tortfeasors who might, under some analyses, escape liability.[166]

One way to address this untidiness is by redefining the harm. In Wright's example, we might seek to hold the poisoner liable not for the victim's death, but for the initial cell damage that had not yet resulted in physical symptoms. *Dillon v. Twin State Gas & Electric Co.*[167] is an example of a court redefining the harm in the opposite direction in an effort to limit the defendant's liability for conduct that arguably constituted a superseding cause of the harm. In *Dillon*, a child fell from a girder and grabbed a steel wire to catch himself.[168] The electric current from the wire killed the child, but had he not been electrocuted, he likely would have fallen to his death.[169]

In assessing the utility company's liability for negligently failing to shield its wires, the *Dillon* court rejected the seemingly obvious finding that electrocution was the sole factual and legal cause of the child's death. Instead, the court reconceptualized the nature of the harm, reasoning that, because the child would have fallen to his death anyway, the utility company was liable not for that death, but merely for any additional harm inflicted by the electrocution.[170] The court's analysis suggests (although obviously does not address) the possibility that, had a third party negligently caused the child to fall from the girder, the intervening electrocution would not have relieved that party of liability, despite the fact that electrocution was the sole factual cause of the child's death.

The idea that a tortfeasor's liability may be determined by the happenstance intervention of another event seems problematic.[171] Why

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164. *See id.*

165. *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 26 cmt. k (Proposed Final Draft No. 1, 2005) ("An act or omission cannot be a factual cause of an outcome that has already occurred.").

166. *See* Alan Schwartz, *Causation in Private Tort Law: A Comment on Kelman*, 63 CHI.-KENT L. REV. 639, 646 n.20 (1987) (describing the result as "[un]acceptable to most observers because consequentialist reasons exist—to deter harm—that justify sanctioning both defendants").

167. Dillon v. Twin State Gas & Elec. Co., 163 A. 111 (N.H. 1932).

168. *Id.* at 112.

169. *Id.* at 114.

170. *See id.* at 115 ("If it were found that he would have thus fallen with death probably resulting, the defendant would not be liable, unless for conscious suffering found to have been sustained from the shock.").

171. *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 27 reporters' note, cmt. h (Proposed Final Draft No. 1, 2005) (observing that the operation of the rules creates an

should the corporate executive who lies to investors at a time when the overall market is rising be held accountable, while another executive who lies just before a stock market crash escapes liability? Perhaps the problem is not in the analysis of causation, but in the definition of the harm. *Dillon* highlights the close relationship between causation and harm, a relationship that is reflected in the *Third Restatement*'s effort to allocate legal responsibility through apportionment of damages rather than through limitations on liability.[172] Tort law has a variety of rules that expressly delineate the scope of recoverable harm—rules that reflect policy judgments about the manageability of litigation and the goals of tort law.[173] In securities fraud litigation, courts have paid relatively little attention to the conceptualization of harm. Part IV considers that question. Before addressing the question of harm, however, the next Section briefly considers the courts' analysis of causal complexity in securities fraud cases.

C. Causal Complexity in Securities Litigation

The courts' application of tort law causation principles, particularly complex causation principles, to securities fraud has been highly imperfect. The problems begin with the courts' reliance on negligence cases despite the fact that securities fraud involves an intentional tort. The courts have modeled the causation requirement in securities fraud on the traditional concepts of but-for and proximate cause;[174] indeed, the courts freely employ these terms, citing to common law authorities such as the *Second Restatement*.[175] Yet, as described above, these concepts play a very different role in intentional torts. Although the common law employs a variety of approaches in intentional tort cases, it often authorizes recovery in fraud cases for harms that would be excluded under the federal courts' current

anomaly in which happenstance timing determines whether an additional cause will constitute a multiple cause that has no legal effect or a preempting cause that relieves the defendant of liability).

172. *See* RESTATEMENT (THIRD) OF TORTS: APPORTIONMENT OF LIAB. § 8 (2000) (apportioning responsibility according to the "nature of [each] person's risk-creating conduct" and "the strength of the causal connection between [such] conduct and the harm"); *see also* Green, *supra* note 134, at 708–09 (arguing that courts often improperly consider "duplicating 'cause[s]'" that never took place or caused any harm and that these factors should instead be viewed as "a matter of harm identification" and reflected in the calculation of damages).

173. The rules include limitations on the scope of actionable harm—such as the preclusion, in some cases, of recovery for emotional distress and economic damage—as well as extensions of the initial tortfeasor's liability to foreseeable wrongful actions by others—such as liability for malpractice committed in treating the original injury.

174. *See, e.g.*, Berckeley Inv. Group, Ltd. v. Colkitt, 455 F.3d 195, 222 (3d Cir. 2006) ("Causation in the securities context is strikingly similar to the familiar standard in the torts context, but with different labels. In the securities realm, 'but for' causation is referred to as 'reliance, or transaction causation,' and 'proximate cause' is known as 'loss causation.'").

175. *See supra* note 23.

loss causation requirement.[176] As a result, despite the Supreme Court's statement in *Dura*,[177] common law fraud does not offer strong support for the causation jurisprudence that courts have developed under Rule 10b-5. In particular, the common law cases do not require that the plaintiff's loss be a foreseeable materialization of the risk concealed by the defendant's misrepresentation.[178] Moreover, missing from the analysis are the policy considerations that typically accompany an analysis of proximate cause in tort law and that have led to the elimination of proximate cause in the *Third Restatement*.

Similarly missing are the principles that common law courts have developed to deal with causal complexity. Securities fraud almost invariably involves causal complexity. If the plaintiff's harm is defined as a drop in stock price[179]—the measure suggested by *Dura* and applied post-*Dura* by the lower courts—then it is necessary to account for the multiple factors other than the defendant's fraud that may have an effect on stock price. These factors include general market fluctuations, industry developments, global political and economic events, and firm-specific developments unrelated to the fraud. Federal courts have uniformly reasoned that defendants are not responsible for stock price movements due to nontortious factors, and litigation post-*Dura* involves the presentation of expert testimony designed to isolate the market price reaction associated with the revelation of the defendant's fraud. Courts impose this requirement not in the calculation of damages, but at the threshold stages of evaluating the sufficiency of the pleadings or authorizing class certification.[180] It is not clear that the process is based on tort principles.

The distortion of common law principles is perhaps most evident in several recent securities cases applying the concepts of superseding and intervening cause. Notwithstanding the tort law limitations on when an intervening event breaks the causal chain, courts have reasoned that the occurrence of nonfraudulent events that contribute to a decline in stock price severs the link between the defendant's fraud and the plaintiff's

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176. *See* Andrew L. Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 TEX. L. REV. 469, 501–06 (1988) (describing various common law cases in which courts have used expansive measures of damages inconsistent with a strict causation requirement).

177. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005) ("Judicially implied private securities fraud actions resemble . . . common-law deceit and misrepresentation actions.").

178. *Cf.* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005) (describing loss causation as requiring "both that the loss be foreseeable and that the loss be caused by the materialization of the concealed risk" (emphasis omitted)).

179. The conceptualization of plaintiff's harm is considered in more detail in Part IV, *infra*.

180. The calculation of damages in securities fraud cases has received relatively little attention and is considered in more detail in Part IV, *infra*.

harm.[181] For example, in *In re Merrill Lynch & Co. Research Reports Securities Litigation*, Judge Pollack found an intervening cause in the "precipitous price decline" resulting from the bursting of the internet bubble.[182] Similarly, in *D.E. & J Ltd. Partnership v. Conaway*, the court identified as intervening events "the events of September 11, 2001, recession[,] . . . the war in Afghanistan[,] . . . . [and] Kmart's bankruptcy filing."[183]

Application of the analysis in *McCarthy*[184] suggests that the courts are allowing subsequent events to break the causal chain too readily. Even if general market movements, a recession, or adverse developments at the company cause a price decline, those events are normal risks of securities investments and therefore are foreseeable to the defendant. Moreover, the consequence of those events—a price decline—is no different from the consequence of the original fraud.

IV. THE HARM IN SECURITIES FRAUD

Both the *Dura* decision and common law tort doctrine highlight the critical connection between causation and harm. But what is the harm to individual investors in a securities fraud case?[185] Following *Dura*'s direction, a possible starting point is the measure of recoverable damages for common law fraud or deceit. The *Second Restatement*[186] authorizes the award of damages as follows:

> § 549. Measure of Damages for Fraudulent Misrepresentation
>
> (1) The recipient of a fraudulent misrepresentation is entitled to recover as damages in an action of deceit against the maker the pecuniary loss to him of which the misrepresentation is a legal cause, including

181. *See, e.g.*, DeMarco v. Robertson Stephens Inc., 318 F. Supp. 2d 110, 122 (S.D.N.Y. 2004) ("If the loss was caused by an intervening event not related to the fraud, then the § 10(b) claim must fail.").

182. *In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 362 (S.D.N.Y. 2003), *aff'd sub nom. Lentell*, 396 F.3d at 161.

183. D.E. & J Ltd. P'ship v. Conaway, 284 F. Supp. 2d 719, 749 n.26 (E.D. Mich. 2003).

184. Canada *ex rel.* Landy v. McCarthy, 567 N.W.2d 496, 507 (Minn. 1997); *see supra* note 162 and accompanying text.

185. The analysis in this Part focuses on the injury suffered by a particular investor who purchases securities at a time when defendants have injected misinformation into the market. This Part does not consider whether investors are systematically injured by the presence of fraudulent information or the potential social costs associated with securities fraud. *See, e.g.*, Fox, *supra* note 85, at 871–72 (identifying possible differences between private costs and social costs, and explaining potential efficiency justifications for imposing liability).

186. *Dura* cites the Second *Restatement of Torts*, not the Third. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343–44 (2005).

> (a) the difference between the value of what he has received in the transaction and its purchase price or other value given for it; and
>
> (b) pecuniary loss suffered otherwise as a consequence of the recipient's reliance upon the misrepresentation.
>
> (2) The recipient of a fraudulent misrepresentation in a business transaction is also entitled to recover additional damages sufficient to give him the benefit of his contract with the maker, if these damages are proved with reasonable certainty.[187]

Consider this approach as applied to the typical securities fraud plaintiff who purchases securities at a time when the defendant's falsely positive statements or concealment of negative information has inflated the market price. The plaintiff pays a price that is higher than he or she would have paid if the market knew the truth. At a subsequent point in time, the fraud is revealed—either directly through a corrective disclosure or indirectly through the occurrence of events that are inconsistent with the original lies. The stock price declines.[188]

Prior to *Dura*, courts commonly characterized the plaintiff's harm in terms of artificial price inflation or overpayment: the plaintiff purchased securities that were overpriced because of the defendant's fraud. This measure appears to correspond to section 549(1)(a) of the *Restatement*—the amount of artificial price inflation reflects the difference between the price the plaintiff paid and the value of the securities received. The *Dura* Court adopted (or at least strongly suggested) an alternative formulation of the plaintiff's harm, concluding that an investor is harmed if and when the price of the purchased securities declines.[189] This characterization of the harm may be termed "outcome harm."[190] Arguably, this measure corresponds to section 549(1)(b)—the pecuniary loss suffered by the plaintiff. Section 549(2) authorizes the recovery of expectation damages in a limited number of common law fraud cases—a measure of damages that courts have generally not permitted in securities fraud cases.[191]

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187. RESTATEMENT (SECOND) OF TORTS § 549 (1977).

188. Analogous reasoning applies in the case of a defrauded seller. Although such cases exist, *see, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 228 (1988); Mitchell v. Tex. Gulf Sulphur Co., 446 F.2d 90, 95–96 (10th Cir. 1971), they are comparatively rare and present fewer concerns about market integrity and moral hazard. For simplicity, this Article focuses on the case of the defrauded purchaser.

189. *See Dura*, 544 U.S. at 342. As discussed below, the shift from an ex ante to an ex post perspective has important implications for the causation analysis.

190. *See* Claire Finkelstein, *Is Risk a Harm?*, 151 U. PA. L. REV. 963, 966 (2003) (using the term "outcome harm" to describe tangible injuries and to distinguish harm from risk of harm).

191. *See* Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962) (explaining that the measure of damages is the plaintiff's "'out

Tort law offers an alternative understanding of *Dura* as grounded in the distinction between risk and injury. Under such an understanding, the plaintiff's purchase at an artificially inflated price creates the risk of injury, but a tangible injury occurs only upon a subsequent drop in stock price. This distinction is well developed in some areas, such as torts involving exposure to hazardous substances. Tort law generally does not treat a risk of harm as actionable.

Finally, the ability of a plaintiff to engage in multiple securities transactions with offsetting effects raises the issue of whether harm should be conceptualized on an aggregate basis. The appropriateness of netting gains and losses that result from the defendant's conduct is considered in Part IV.D.

A. ARTIFICIAL PRICE INFLATION

Securities fraud decisions rarely address damages. When they do, they describe recoverable damages as the plaintiff's "out-of-pocket" loss. As the Supreme Court explained in 1900, out-of-pocket loss is "'the difference between the real value of the stock *at the time of the sale*, and the fictitious value at which the buyer was induced to purchase.'"[192] Similarly, the Court in *Randall v. Loftsgaarden* described the normal measure of damages in a 10b-5 case as the plaintiff's "out-of-pocket" loss—that 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.'"[193]

The difference between the price that the plaintiff paid and what the securities were really worth may be the most natural description of the plaintiff's harm from securities fraud. This measure approaches damages from an ex ante perspective by asking what the securities would have been worth at the time of the purchase absent the fraud. The difference between the purchase price and the "true value" is the amount by which the misrepresentation artificially inflated the purchase price, or the amount that the plaintiff overpaid.

The standard method of establishing artificial price inflation is to ascertain what the stock price would have been in the absence of the fraud. Thus, the concept of artificial price inflation is closely tied to the methodology of financial economics in which investments are valued on the basis of their expected future cash flows. Investors use information about the issuer to predict future cash flows, and in an efficient market, the market

of pocket'" loss, which is "not what the plaintiff might have gained, but what he has lost by being deceived into the purchase"). The extent to which an award of expectation-based damages would be consistent with the limiting language of the PSLRA is unclear.

192. Sigafus v. Porter, 179 U.S. 116, 124 (1900) (emphasis added) (quoting High v. Berret, 23 A. 1004, 1004 (Pa. 1892)).

193. Randall v. Loftsgaarden, 478 U.S. 647, 661–62 (1986) (alteration in original) (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972)).

price reflects this information. The logic of *Basic* is premised upon the assumption that misinformation, by misleading the market, has the effect of distorting market price. Under the pre-*Dura* approach, expert economists reconstructed the stock's value at the time of the purchase based on various methods of modeling the amount of fraud-induced price inflation.[194]

The rationale for using artificial price inflation as a measure of damages is that the plaintiff's damage occurs at the time of purchase; the plaintiff is damaged by overpaying for the purchased stock. Events that occur subsequent to the purchase may assist the trier of fact in ascertaining the stock's value at the time of purchase, but a subsequent decline in purchase price is not an independent actionable harm, whether or not it relates to the subject of the misrepresentations. Ex post developments are, by definition, irrelevant.

Despite the attractions of this characterization of the plaintiff's harm—both its consistency with modern finance theory and the simplicity that it lends to causation analysis—the *Dura* Court was fairly clear in rejecting it. As the Court stated, "at the moment the transaction takes place, the plaintiff has suffered no loss."[195] What did the Court mean by this statement? The absence of a realization event—a subsequent transaction in which the plaintiff sells the stock for its true value—should not be fatal to the plaintiff's claim that he or she has overpaid. Tort law does not require a plaintiff who purchases a piece of glass in place of a diamond to sell that piece of glass in order to establish his or her claim of fraud.

One reason why tort law does not require a realization event is that, in most cases, the discrepancy between the object's true value and its value as fraudulently represented is readily ascertainable. It is clear that the piece of glass is worth far less than a genuine diamond, and a determination of the "true value" of the glass is reasonably straightforward. Valuation in securities litigation, however, is more complicated.[196] The estimates and predictions

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194. *See, e.g.*, David Tabak & Chudozie Okongwu, Inflation Methodologies in Securities Fraud Cases: Theory and Practice (July 2002) (unpublished manuscript), *available at* http://ssrn.com/abstract=315919 (describing common approaches to measuring artificial price inflation); *see also* David Tabak, Inflation and Damages in a Post-*Dura* World 3, 6–12 (Sept. 25, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=1017334 (stating that pre-*Dura*, a plaintiff's losses were typically asserted to be the amount of artificial price inflation, and describing the effect of *Dura* on damages methodology).

195. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005).

196. In addition, although most commentators agree that the securities markets are efficient in the sense that information is incorporated into stock price, there is far less consensus that the resulting market prices represent the "true value" of the securities in question. *See* Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 20 (1994) ("[O]verwhelming empirical evidence suggests that capital markets are not fundamentally efficient."); Jill E. Fisch, *Picking a Winner*, 20 J. CORP. L. 451, 463–64 (1995) (book review) (explaining the difference between informational efficiency and fundamental-value efficiency); *see also* Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42

that form the basis of an expert's reconstruction of value are imprecise, and there is the risk that subsequent stock price developments may influence the expert's opinion, particularly if the stock price drop occurs upon disclosure of the fraud. In addition, stock price is "a dynamic, not a static, concept and the market may re-evaluate and re-price a stock on a daily, hourly or even momentary basis."[197]

Dura, then, may reflect an evidentiary problem—the Court's skepticism about the accuracy with which experts can reconstruct the stock's hypothetical value in a world of full disclosure. It is far easier to conclude that the plaintiff overpaid if the fraud is subsequently revealed and the stock price drops in response to that disclosure.[198] The price drop is compelling circumstantial evidence that the price was artificially inflated at the time of the purchase,[199] but even if a subsequent price drop is strong evidence of overpayment, it is unclear why it would be the only acceptable basis for establishing price inflation. As a practical matter, plaintiffs may have recourse to other evidence.[200]

Alternatively, the *Dura* Court may have been rejecting the theory that overpayment is, in itself, an actionable harm, concluding instead that harm requires an actual decline in market price. This reading of *Dura* is strongly supported by the Court's statement that "the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value."[201] The statement seems to indicate that because the stock can be sold at the market price, the market price reflects the stock's true value, and there is no economic loss unless or until the stock price falls below the purchase price. Of course, this reasoning is directly at odds with the rationale behind the *Basic* decision.[202] The shift from an ex ante perspective

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STAN. L. REV. 1059, 1077–79 (1990) (questioning whether the *Basic* Court's conception of market efficiency supports its adoption of fraud on the market).

197. Madge S. Thorsen et al., *Rediscovering the Economics of Loss Causation*, 6 J. BUS. & SEC. L. 93, 95 (2006).

198. As later discussion explains, the task of separating the price effect associated with the corrective disclosure from that due to unrelated causes is, in fact, considerably more challenging than it may initially appear.

199. *See* Transcript of Oral Argument at 9, *Dura*, 544 U.S. 336 (No. 03-932), *available at* http://www.supremecourtus.gov/oral_arguments/argument_transcripts/03-932.pdf (recording the petitioners' argument that actual marketplace decline in value is a better indicator than speculation as to what the price would have been at the time of purchase).

200. *See, e.g.*, Scott D. Hakala, Current Economic and Expert Issues in Securities Litigation 18–23 (Feb. 1, 2006) (unpublished manuscript, on file with the Iowa Law Review), *available at* https://plusweb.org/files/Events/all.star7Econ.%20Issues%20-%20Securities%20Lit.pdf (describing other methods of establishing price inflation).

201. *Dura*, 544 U.S. at 342.

202. Madge Thorsen and others have attempted to address the *Dura* language by characterizing the plaintiff's loss as artificial price inflation that the plaintiff cannot recoup. *See* Thorsen et al., *supra* note 197, at 98. The authors argue that, like the price of the stock, the inflationary component of that price can fluctuate and that the plaintiff's loss is measured by

to an ex post perspective reflected in the switch from artificial price inflation to outcome harm has important implications for causation analysis.

B. Outcome Harm

The conception of the plaintiff's harm that seems most consistent with the language in *Dura* is a drop in the stock price subsequent to the plaintiff's purchase. Under this approach, "a plaintiff's damages are equal to the difference between what it paid to purchase securities and how much it received when it sold those securities."[203] There is nothing inherently unreasonable about describing the plaintiff's harm in this way; indeed, an investor is more likely to perceive his or her loss as the amount of the price drop rather than the amount of overpayment. Looking to the price drop also avoids the need to establish the counterfactual price of the stock under circumstances that did not, in fact, occur.

Focusing on the subsequent stock price drop reopens the issue of realization. If *Dura*'s holding is premised on the theory that the plaintiff's loss is not real until the stock price drops, it is unclear why a price drop without a sale is sufficient.[204] Arguably, a stock price drop does not cause a plaintiff actual economic harm unless and until the plaintiff sells the stock.[205] A paper loss is not the equivalent of an out-of-pocket loss; the investor can always recoup the loss if the price subsequently rises. Indeed, the PSLRA recognizes the possibility that the stock price will rebound and limits the amount of the plaintiff's recoverable loss to the difference

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the difference between the amount of inflation at the time of his or her purchase and the inflation at the time of the subsequent sale. *Id.* Of course, if the *Dura* Court's concern is that measuring artificial price inflation is speculative, this alternative characterization of the loss is more problematic because the court must determine both the original amount of price inflation and the extent to which subsequent developments have affected the inflationary component, as opposed to the stock's true value. Thorsen and her co-authors advocate the use of expert testimony to solve this problem. *See id.* at 109–13 (discussing event studies and other valuation techniques).

203. Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp., 315 F. Supp. 2d 666, 679 (E.D. Pa. 2004); *see also* Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) ("Where the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation.").

204. *See In re* CIGNA Corp. Sec. Litig., 459 F. Supp. 2d 338, 343 n.5 (E.D. Pa. 2006) (discussing the testimony of the plaintiff's expert, who distinguished between an "investment loss"—i.e., where the stock is sold at less than the purchase price—and an "economic/ inflationary loss"—i.e., where stock is purchased at an inflated price and then sold (or held until the end of the class period) at a less inflated price).

205. For example, under the Internal Revenue Code, an investor generally does not realize a loss until he or she sells the stock. Michelle Arnopol Cecil, *Bankruptcy Reform: What's Tax Got to Do with It?*, 71 MO. L. REV. 879, 886 (2006) ("Under the Tax Code, gain [or loss] inherent in property is not recognized . . . until there is a realization event, which is loosely defined as a sale or other disposition of the property." (citing I.R.C. § 1001(a), (c) (2000))).

between the price paid by the plaintiff and the mean trading price during the ninety-day period following disclosure of the fraud.[206]

Similarly, defining harm as a drop below the purchase price would prevent plaintiffs from recovering if the stock price does not fall. Even if a plaintiff is misled into overpaying, market movements or unrelated issuer developments may cause the stock price to rise beyond the purchase price. *Dura* does not address the question of whether a plaintiff can recover damages for securities fraud when the stock price has increased due to unrelated factors, although Justice Breyer posed this question to counsel at oral argument.[207] At least a few lower courts have held that a plaintiff does not suffer an economic loss if the stock price does not fall below the purchase price.[208]

Putting aside the issue of realization, the move to an ex post measure of damages creates an additional problem in that, although the defendant's fraud may cause the stock price to rise, it is the revelation of that fraud—or, more likely, the disclosure of the issuer's true financial condition—and not the fraud itself that causes the subsequent price drop. As then-Chief Judge Winter put it: "The issue is not whether a misstatement 'caused' a loss. . . . For example, losses due to insolvency, much less insolvency itself, are not 'caused' by misrepresentations."[209]

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206. 15 U.S.C. § 78u-4(e)(1) (2000). If the plaintiff sells the securities prior to the expiration of the ninety-day period, the sale cuts off the period of time for calculating the mean trading price. *Id.* § 78u-4(e)(2).

207. *See* Transcript of Oral Argument, *supra* note 199, at 7–10 (questioning whether a plaintiff would have a loss if he purchased stock based on misrepresentations that the company had gold, when the company never had gold but subsequently found platinum, causing the stock price to rise).

208. *See, e.g.*, *In re* Estee Lauder Cos. Sec. Litig., No. 06 Civ. 2505 (LAK), 2007 U.S. Dist. LEXIS 38491, at *5 (S.D.N.Y. May 21, 2007). The court noted:

> As it is perfectly plain that plaintiff would have profited if he sold after September 11, 2006, may have profited even if he sold before September 11, 2006, and may well profit in the future if he has not yet sold, this complaint patently fails to plead loss causation for this reason alone.

Id. (footnotes omitted). Likewise, the court in *In re Veeco Instruments Inc. Securities Litigation* stated:

> Plaintiffs' damages calculations could not include Class Members who purchased Veeco stock during the Class Period and either sold it at a profit, or retained it past the point after the Class Period when the stock price first recovered to the price at which the shares were purchased . . . because such Class Members can prove no economic loss that is attributable to any of the Defendants' alleged misrepresentations.

In re Veeco Instruments Inc. Sec. Litig., No. 05 MDL 01695 (CM), 2007 U.S. Dist. LEXIS 85629, at *31 (S.D.N.Y. Nov. 7, 2007).

209. AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 235 (2d Cir. 2000) (Winter, C.J., dissenting); *cf. In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 364 (S.D.N.Y. 2003) (dismissing a complaint because "plaintiffs have not alleged that there was any

An ex post analysis also complicates the evidentiary issue involved in measuring value. First, because corrective disclosures are often prompted by the materialization of an undisclosed risk, the stock price drop in response to such a disclosure is likely to reflect that materialization rather than simply nondisclosure of the risk itself.[210] The ex post stock price drop may well be greater than the initial price inflation even if the stock price drop is entirely responsive to the corrective disclosure.[211] In addition, the disclosure reveals not just the underlying bad news, but also the fact that it was fraudulently concealed. The market reaction to this revelation may reflect concerns about issues such as management integrity and the anticipated likelihood of future litigation.

Second, a price drop—whether in response to a corrective disclosure or other events that reveal the truth—is likely to occur weeks or even months after the defendant's misrepresentation and the plaintiff's purchase. This lag typically is substantial. Jim Cox and Randall Thomas found that the median length of a class period—the time between the misstatement and the revelation of the truth to the market—is 10.5 months.[212] During this 10.5-month period, the intervention of other factors that contribute to a stock price decline is more than foreseeable—it is likely.[213] The court is then left with the task of sorting out the extent of this loss for which the defendant should be held responsible. Significantly, this task is precisely the type of inquiry traditionally handled in tort law through the doctrine of proximate cause. As Prosser and Keeton explain: "Once it is established that the defendant's conduct has in fact been one of the causes of the plaintiff's injury, there remains the question whether the defendant should be legally responsible for the injury."[214] The *Third Restatement* characterizes this

link between the allegedly overly optimistic ratings and the financial troubles of 24/7 or Interliant that led to their financial demise in the wake of the bursting [Internet] bubble"), *aff'd sub nom.* Lentell v. Merrill Lynch & Co., 396 F.3d 161 (2d Cir. 2005).

210. Jonathan Macey and Geoffrey Miller make this point with respect to the *Basic* case, observing that a stock price reaction to the announcement of the merger might not mean that the market was misled by *Basic*'s denial of merger negotiations, but might instead mean that "the market does not value a merger negotiation as highly as a merger agreement." Macey & Miller, *supra* note 196, at 1088.

211. One reason why the stock price drop may be greater is that investors may anticipate the costs of subsequent litigation over the fraud.

212. James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 429 (2005).

213. The *Dura* Court acknowledged as much. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005) ("Other things being equal, the longer the time between purchase and sale, . . . the more likely that other factors caused the loss.").

214. KEETON ET AL., *supra* note 23, § 42, at 272–73 (footnote omitted).

determination as a policy judgment rather than a scientific inquiry.[215] The pedigree of proximate cause dates back more than 100 years. As set out by the Supreme Court in 1876:

> The true rule is, that what is the proximate cause of an injury is ordinarily a question for the jury. It is not a question of science or of legal knowledge. It is to be determined as a fact, in view of the circumstances of fact attending it. The primary cause may be the proximate cause of a disaster, though it may operate through successive instruments, as an article at the end of a chain may be moved by a force applied to the other end, that force being the proximate cause of the movement, or as in the oft-cited case of the squib thrown in the market-place.[216]

Although tort law takes seriously the proximate cause inquiry—the task of determining the harms for which the defendant is legally accountable—securities law does not. The federal courts have generally assumed, with little or no discussion, that the defendant's responsibility is limited to the amount of the price drop attributable to the fraud;[217] indeed, courts have rejected expert opinions that failed to use event studies or comparable methodology to account for unrelated market movements and similar factors.[218] Recent opinions describe recoverable damages as the amount of ex ante price inflation that is subsequently removed from the stock price through a corrective disclosure or other event, limited by the extent to which the subsequent stock price drop can be attributed to other factors.[219]

The rationale for imposing this limit on liability is unclear. A plaintiff's pecuniary or out-of-pocket loss is, after all, the difference between the purchase price and the (actual or potential) sale price. If we take the preceding discussion seriously, the full amount of that loss is real. To the extent that other causal factors contributed to the loss, the defendant's responsibility for that loss should, under tort law, depend on complex causation analysis. But the federal courts' references to these principles have been limited and incorrect.

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215. *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL HARM § 34 cmt. a (Proposed Final Draft No. 1, 2005) (noting the shift away from "legal scientism" in determining proximate cause).

216. Milwaukee & Saint Paul Ry. Co. v. Kellogg, 94 U.S. 469, 474 (1876).

217. *See, e.g.*, *In re* Executive Telecard, Ltd. Sec. Litig., 979 F. Supp. 1021, 1025 (S.D.N.Y. 1997) (stating that damage calculation "require[s] elimination of that portion of the price decline that is the result of forces unrelated to the wrong"); *In re* Oracle Sec. Litig., 829 F. Supp. 1176, 1181 (N.D. Cal. 1993) (explaining the need "to distinguish between the fraud-related and non-fraud related influences on the stock's price behavior").

218. *Executive Telecard*, 979 F. Supp. at 1027 (explaining that the expert's "failure to conduct a thorough 'event study' would be reason enough to exclude his proposed testimony").

219. *See, e.g.*, *In re* CIGNA Corp. Sec. Litig., 459 F. Supp. 2d 338, 349 (E.D. Pa. 2006) (describing case law concerning economic loss). Damages are also limited by the ninety-day look-back provision.

First, as indicated above, courts have applied an erroneous conception of intervening cause. Under traditional tort law principles, an intervening cause does not automatically limit or eliminate the defendant's liability. Rather, the intervening cause must be sufficient to justify denying liability that the defendant otherwise would bear. In particular, the intervening cause must not be foreseeable.[220] Yet the occurrence of market forces and firm-specific developments that impact firm value is not just foreseeable—it is virtually assured. These developments will predictably cause the stock price to fluctuate, and with any security, there is a predictable risk that the fluctuations will result in a drop in stock price. By inducing the plaintiff to invest in the subject securities, the defendant knowingly exposes the plaintiff to the risk of the resulting loss. Nor is the loss from a market decline different in kind from a loss due to a corrective disclosure; in both cases, the drop in stock price reduces the value of the securities that the plaintiff was fraudulently persuaded to purchase.

Second, the common law does not uniformly relieve defendants of liability in multiple causation cases, even where innocent factors contributed to the plaintiff's harm. Rather, under the common law, the presence of multiple causal factors does not eliminate liability so long as the defendant's conduct is a factual cause of the harm. The *Third Restatement* contains extensive commentary on how to allocate responsibility for damages in cases of multiple causation and looks to policy considerations such as culpability, recognizing that the allocation is not a scientific inquiry. Although event studies can link a stock price reaction to an information event, they cannot determine the extent to which that stock price reaction is the right measure of recoverable harm.

Third, there are reasons to be concerned about judicial efforts to divide stock-drop harm between that which is fraud-based and that which is due to nonfraudulent factors.[221] Market and other informational developments do not operate on stock price independently but in combination. Their effect on any given company depends on firm-specific characteristics.[222] The stock

220. Indeed, under tort law, an initial tortfeasor is liable for any additional harm caused by the malpractice of a treating doctor; this malpractice does not constitute a superseding cause. RESTATEMENT (SECOND) OF TORTS § 457 (1965).

221. This concern is heightened to the extent that plaintiffs bear the burden of establishing this allocation to a degree of scientific certainty. *See, e.g.*, *In re* Omnicom Group, Inc. Sec. Litig., 541 F. Supp. 2d 546, 554 (S.D.N.Y. 2008) (rejecting an event study that disaggregated only some but not all of the potentially confounding factors as insufficient "to establish that the alleged misrepresentations actually caused Plaintiffs' loss").

222. For example, some commentators have observed that increased industry regulation, although costly, may be advantageous for large or established companies because they are able to bear the costs and the regulation may reduce competition. *See, e.g.*, Jill E. Fisch, *How Do Corporations Play Politics?: The FedEx Story*, 58 VAND. L. REV. 1495, 1551–52 (2005) (describing how congressional adoption of new noise regulations benefitted FedEx at the expense of its small competitors).

price of a financially troubled issuer is likely to respond more dramatically to negative market developments than that of a healthy company.[223] Announcements of adverse developments at one company may affect the stock prices of other companies in the same industry. These interactions may taint the accuracy of experts' adjustments for industry or market developments.

Perhaps most troublingly, corporate decisionmakers are often able to control the timing of their disclosures, enabling them to manipulate the extent to which the company's stock price reacts to a corrective disclosure. Faced with the need to reveal their fraud, defendants can deliberately introduce additional causal factors. For example, before disclosing a fraud, corporate officials may release "unrelated" negative information that preemptively reduces stock price. This behavior is sometimes described as "walking down the stock price."[224] Defendants also may bundle a corrective disclosure with good news that offsets the effect of the negative information on stock price.[225] Still another alternative is to delay a corrective disclosure until immediately after market or industry bad news has caused stock prices to fall. This control over market information offers a substantial policy justification for limiting the role of other causal factors in reducing defendants' responsibility.

C. Risk Versus Injury—Another View of Dura

The foregoing discussion has read the *Dura* decision as endorsing an ex post stock price drop, or some portion thereof, as the correct measure of a plaintiff's economic injury. An alternative rationale for *Dura*'s holding is the tort law distinction between risk and injury. One can characterize the defendant's original misstatements as causing not a present harm (reflected

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223. Indeed, the interaction of the fraud and other market developments arguably resembles the increased sensitivity of some tort victims to physical injury, as reflected in the thin-skull rule. *See* RESTATEMENT (SECOND) OF TORTS § 461 (1965) (subjecting a defendant "to liability for harm to another although a physical condition of the other . . . makes the injury greater than that which the actor as a reasonable man should have foreseen as a probable result of his conduct"). Similarly, it is plausible that companies involved in fraud are especially susceptible to ruinous harm upon the occurrence of adverse economic events. Indeed, many of the companies that collapsed due to the bursting of the dot-com bubble—as opposed to weathering it—were those engaged in financial accounting manipulations and similar practices.

224. *See, e.g.*, Coughlin et al., *supra* note 75, at 26 ("[S]ecurities-fraud perpetrators could just as easily 'walk down' the stock price by the selective disclosure of seemingly unrelated 'bad' news concerning the company and thereby avoid a sudden stock-price reaction, and insulate themselves from liability."); Ann Morales Olazábal, *Loss Causation in Fraud-on-the-Market Cases Post-*Dura Pharmaceuticals, 3 BERKELEY BUS. L.J. 337, 370 (2006) (criticizing the Eleventh Circuit's decision in Robbins v. Koger Props., Inc., 116 F.3d 1441 (11th Cir. 1997), for allowing issuers to "'walk' the stock price down with other bad news").

225. *See, e.g.*, James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After* Dura Pharmaceuticals, 95 GEO. L.J. 653, 674–80 (2007) (describing how bundling can enable firms to mask fraud-related losses).

in the overpayment) but a risk of future harm. It is not until that future harm occurs (in the form of a stock price drop related to the disclosure of the fraud) that the plaintiff is damaged. This description is consistent with *Dura*'s statement that "the most logic alone permits us to say is that the higher purchase price will *sometimes* play a role in bringing about a future loss."[226] The tort literature's exploration of the distinction between risk and injury offers a potentially useful window into the *Dura* decision.

Tort law does not permit a private plaintiff to recover without proof of injury,[227] and the dominant view in torts is that a risk of future harm does not, in itself, constitute an injury.[228] As Matt Adler explains, the reason for this limitation is that applying the concept of risk, which is probabilistic, to a single individual and outcome is problematic.[229] We can speak of probabilities, and therefore of increased risk, with respect to groups, but for any individual plaintiff, the defendant's conduct either causes outcome harm (in which case the defendant should be liable) or does not (in which case the plaintiff arguably has suffered no actionable injury). Although risk may constitute a form of injury that is distinct from the harm that occurs if that risk materializes, tort law generally does not compensate plaintiffs for that injury.[230]

Common law principles, then, arguably justify the move from price inflation to outcome harm. But it is not clear that the tort law analogy makes sense here. The tort law analysis of risk as a distinct harm generally occurs in products-liability or hazardous-substance-exposure cases. Although scientific evidence can establish the probability that a plaintiff will suffer harm, there is no way of scientifically quantifying that risk for a specific plaintiff. In

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226. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005).

227. *See, e.g.*, Pasley v. Freeman, (1789) 100 Eng. Rep. 450, 457 (K.B.) (stating that in a case of fraud or deceit, if "no injury is occasioned by the lie, it is not actionable[,] but if it be attended with a damage, it then becomes the subject of an action"); *see also* Goldberg & Zipursky, *supra* note 113, at 1636–41 (describing the injury requirement in tort law).

228. Consider recent decisions addressing this question: *Paz v. Brush Engineered Materials, Inc.*, 949 So. 2d 1, 9 (Miss. 2007) ("This Court has continuously rejected the proposition that within tort law there exists a cause of action or a general category of injury consisting solely of potential future injury."); *Lowe v. Philip Morris USA, Inc.*, 142 P.3d 1079, 1086–91 (Or. Ct. App. 2006) (rejecting a claim that increased risk of harm constitutes cognizable injury). *But see* Jean Macchiaroli Eggen, *Toxic Reproductive and Genetic Hazards in the Workplace: Challenging the Myths of the Tort and Workers' Compensation Systems*, 60 FORDHAM L. REV. 843, 888–93 (1992) (describing the imposition of liability for the creation of risk in limited situations); Finkelstein, *supra* note 190, at 967–86 (recognizing that very few tort cases award compensation for risk alone, but nevertheless describing risk as a distinct injury from outcome harm and identifying case law supporting this conception).

229. *See* Matthew D. Adler, *Risk, Death and Harm: The Normative Foundations of Risk Regulation*, 87 MINN. L. REV. 1293, 1341–42 (2003). Stephen Perry's analysis is similar. *See* Stephen R. Perry, *Risk, Harm, and Responsibility*, *in* PHILOSOPHICAL FOUNDATIONS OF TORT LAW, *supra* note 112, at 321, 330–39.

230. *See* Goldberg & Zipursky, *supra* note 113, at 1636 ("Criminal law sometimes prohibits and punishes genuinely inchoate wrongs—uncompleted wrongful acts. Tort law does not.").

contrast, the value of securities is a function of their return and the associated risk. Increasing the risk of an investment reduces its value to all investors. Thus, increased risk in the capital markets, unlike in traditional torts, is a real, and not a hypothetical, harm.

Indeed, understanding that risk in the capital markets is real and quantifiable, rather than probabilistic and speculative, takes us further and offers an alternative way of characterizing the plaintiff's harm. Securities fraud takes place in the context of an investment decision in which a plaintiff voluntarily enters into a transaction involving known and accepted risks. A plaintiff's assessment and pricing decision are based on an evaluation of those risks. By lying about the issuer and its financial condition, the defendant distorts the plaintiff's ability to make an informed investment decision. The economic significance of the lie is in how it relates to the known risks at the time of investment, not the extent to which those risks materialize and result in harm. In a sense, the plaintiff's injury is akin to a failure to get true odds in a bet.

Courts have difficulty conceptualizing this harm because the damage is to an expectancy interest. A critical difference between tort law and contract law is that tort law generally does not protect expectancy interests, while contract law does. This distinction is enforced through the economic-loss doctrine, which provides that plaintiffs cannot recover in unintentional tort cases for purely economic harms.[231] Courts, however, often protect expectancy interests in those areas of tort law that approach the tort–contract divide, such as fraudulent misrepresentation cases.[232] Nonetheless, the reluctance to protect expectancy interests has generally been applied to federal securities fraud.[233] This reluctance is somewhat counterintuitive in that an investment decision is quintessentially an expectancy interest. As indicated above, investors value securities based on their *expected* future cash flows. A defendant's misrepresentation changes those *expected* cash flows and hence the investment's value at the time of purchase, regardless of the ex post value of the cash flows.

A simplified example, based loosely on the facts of the *Dura* case, is illustrative. Imagine that Dura had two products in development, Ceclor and

231. *See* Michael D. Lieder, *Constructing a New Action for Negligent Infliction of Economic Loss: Building on Cardozo and Coase*, 66 WASH. L. REV. 937, 944–46 (1991) (describing the economic-loss doctrine and tracing its history).

232. In cases involving fraudulent misrepresentations, the majority of jurisdictions allow plaintiffs to recover expectancy-type, benefit-of-the-bargain damages, rather than merely out-of-pocket damages. *See* DAN B. DOBBS, LAW OF REMEDIES: DAMAGES–EQUITY–RESTITUTION § 9.2(1), at 695 (abr. 2d ed. 1993) (explaining that benefit-of-the-bargain damages in misrepresentation claims are like expectancy damages in contract claims).

233. Justice Kennedy posed the question at the oral argument of *Dura*. *See* Transcript of Oral Argument, *supra* note 199, at 12–13 ("[I]n your view, is the plaintiff entitled to an expectancy measure of damage, or is it more the traditional tort measure which is out-of-pocket losses?").

AlSpiros. Dura disclosed information about the prospects of the two products, upon which the market calculated the following probabilities:

- 25% chance that only Ceclor will be successful
- 25% chance that only AlSpiros will be successful
- 10% chance that both products will be successful
- 40% chance that neither product will be successful

Assume now that at the time of its public statements, Dura knew, but did not disclose, that AlSpiros created an unacceptable risk of cancer and would not receive FDA approval. Had Dura disclosed accurately, the market would have calculated the following:

- 35% chance that Ceclor will be successful
- 65% chance that neither Ceclor nor AlSpiros will be successful

The plaintiff's investment decision is distorted by the lost 35% chance that AlSpiros would be successful, and the plaintiff has suffered a loss based on the 35% probability of receiving future cash flows attributable to the successful development and marketing of AlSpiros. The lost opportunity, which exists whether or not Ceclor is successful, is part of the option value associated with the plaintiff's investment.[234] This option value is readily quantifiable, and in fact, a variety of options based on the future returns associated with the underlying security are commonly sold in the capital markets.

The problem, from a tort perspective, is that even if the lost option has an ascertainable value, it is difficult to establish that the nonexistence of the option was a but-for cause of the stock price drop that occurred when the fraud was disclosed. After all, the defendant claimed that AlSpiros had only a 35% chance of success. Whether or not the market was distorted by lies, it was more likely than not that AlSpiros would fail. The calculus becomes even more difficult if we change the hypothetical so that AlSpiros has a real but negligible chance of success, because now the market reaction in response to the revelation of AlSpiros's failure likely overstates the effect of the defendant's lie.

234. When an investor purchases a security, part of the value of that security reflects the possibility that the value of the security will increase in the future due to uncertain developments. The contingent value of the security associated with these uncertainties is option value. RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 597–616 (8th ed. 2006) (describing this option value, embedded in an asset, as a "real option").

One approach used by some common law courts to protect this type of expectancy interest is the doctrine of lost chance.[235] The lost-chance doctrine allows plaintiffs to recover when they cannot establish that the defendant's tortious conduct caused their injuries but can establish some probability that nontortious conduct would have reduced or prevented those injuries. Lost-chance cases most commonly involve medical malpractice in which a plaintiff cannot prove that proper medical treatment would have saved the decedent's life but can prove that such treatment would have created some increased statistical probability of survival.[236] The defendant's negligence—the failure to provide such treatment—denied the decedent this chance.

The lost-chance cases are mixed, and the decisions reflect some disagreement on what the doctrine means. Some courts appear to frame their analysis largely in evidentiary terms.[237] A few courts and commentators have suggested that lost chance is a distinct cause of action.[238] The majority of cases, however, locate the doctrine within causation analysis. Under a traditional causation view, the plaintiff in a lost-chance case cannot establish but-for causation because the outcome, even with proper medical treatment, is speculative.[239] The lost-chance doctrine allows a plaintiff's claim to reach a

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235. One of the oldest-known cases to apply the lost-chance doctrine was a 1911 English case in which the court awarded the plaintiff damages for the lost chance to win a beauty contest. Chaplin v. Hicks, [1911] 2 K.B. 786 (C.A.). The defendant failed to notify the plaintiff, a finalist, that she had qualified for an interview. *Id.* at 787–88. The court determined that the plaintiff's lost chance to win, although only 25%, was sufficient to permit recovery. *See id.* at 790–93.

236. The issue in these cases is not the probabilistic nature of the plaintiff's evidence of causation, but the failure of such evidence to satisfy the "more likely than not" causation standard. This challenge is analogous, in some ways, to the determination of causation in cancer torts. *See* Donald T. Ramsey, *The Trigger of Coverage for Cancer: When Does Genetic Mutation Become "Bodily Injury, Sickness, or Disease"?*, 41 SANTA CLARA L. REV. 293, 309–10 (2001) (describing casual factors that may lead to the development of cancer); Barton C. Legum, Note, *Increased Risk of Cancer as an Actionable Injury*, 18 GA. L. REV. 563, 579–80 & n.68 (1984) (describing cancer torts as presenting the problem of multiple causation). Commentators have suggested alternative methodologies for addressing causation problems in this context. *See, e.g.*, Glen O. Robinson, *Multiple Causation in Tort Law: Reflections on the DES Cases*, 68 VA. L. REV. 713, 755 (1982) (proposing a risk-contribution approach).

237. *See, e.g.*, Stephen A. Bullington, *Arizona's Loss of a Chance Doctrine: Not a Cause of Action, but More than an Evidentiary Rule*, ARIZ. ATT'Y, Jan. 1997, at 28, 33 (describing Arizona's lost-chance doctrine as "a powerful evidentiary rule").

238. *See, e.g.*, Roberts v. Ohio Permanente Med. Group, Inc., 668 N.E.2d 480, 483–84 (Ohio 1996) (recognizing a cause of action for lost chance of recovery); George J. Zilich, Note, *Cutting Through the Confusion of the Loss-of-Chance Doctrine Under Ohio Law: A New Cause of Action or a New Standard of Causation?*, 50 CLEV. ST. L. REV. 673, 682–85 (2002–2003) (describing the distinction between lost chance as a distinct cause of action and a new standard of causation).

239. *See, e.g.*, Simmons v. W. Covina Med. Clinic, 260 Cal. Rptr. 772, 776 (Ct. App. 1989) ("A less than 50-50 possibility that defendants' omission caused the harm does not meet the requisite reasonable medical probability test of proximate cause."); Cooper v. Sisters of Charity of Cincinnati, Inc., 272 N.E.2d 97, 103 (Ohio 1971) ("We consider the better rule to be that in

jury even if his evidence is insufficient to establish that the doctor's negligence was a but-for cause of the adverse medical outcome.

An alternative approach is to view the lost-chance doctrine as a reformulation of the decedent's injury, not in terms of outcome harm, but as the lost chance of survival. The defendant's conduct did not cause, directly or indirectly, the decedent's death; it merely deprived the decedent of a treatment that might have prevented that death. Some courts have adopted this approach explicitly.[240] Many commentators have defended this analysis, both because it preserves the formal causation requirements and because it reflects a modern and realistic conception of the nature of the harm that the defendant's conduct inflicts.[241] In particular, this approach reduces the risk of unfairly exposing defendants to liability for causal factors beyond their control, such as by holding a doctor liable for a patient's wrongful death when the doctor's malpractice only reduced the patient's likelihood of survival by 10%. Defining the patient's injury as the lost chance, rather than the outcome harm, limits the defendant's liability.[242]

The application of the lost-chance doctrine outside the medical-malpractice area and, in particular, to speculative economic gains is very limited.[243] Nonetheless, the principles appear readily applicable to securities fraud. Returning to the *Dura* hypothetical, rather than describing the defendant's conduct as exposing the plaintiff to an increased risk of loss, the plaintiff can be said to suffer the loss of the chance that AlSpiros would be successful and the future cash flows that would result from that success. Reformulating the plaintiff's loss in terms of a lost chance has the advantage of limiting the problematic ex post analysis associated with outcome harm and is consistent with current judicial efforts to limit defendants' responsibility for losses caused by subsequent events such as overall market movements.

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order to comport with the standard of proof of proximate cause, plaintiff in a malpractice case must prove that defendant's negligence, in probability, proximately caused the death."), *overruled by Roberts*, 668 N.E.2d at 483–84 (recognizing the lost-chance doctrine).

240. *See, e.g.*, DeBurkarte v. Louvar, 393 N.W.2d 131, 137 (Iowa 1986) ("We believe the better approach is to allow recovery, but *only* for the lost chance of survival.").

241. *See, e.g.*, Nancy Levit, *Ethereal Torts*, 61 GEO. WASH. L. REV. 136, 155–56 (1992) ("Courts and commentators explicitly acknowledge that the compensable injury is the lost chance itself.").

242. *See* Herskovits v. Group Health Coop. of Puget Sound, 664 P.2d 474, 479 (Wash. 1983) ("Causing reduction of the opportunity to recover (loss of chance) . . . does not necessitate a total recovery against the negligent party for all damages caused by the victim's death. Damages should be awarded to the injured party or his family based only on damages caused directly by premature death . . . .").

243. *But see* Miller v. Allstate Ins. Co., 573 So. 2d 24, 29 (Fla. Dist. Ct. App. 1990) ("It is now an accepted principle of contract law . . . that recovery will be allowed where a plaintiff has been deprived of an opportunity or chance to gain an award or profit even where damages are uncertain.").

D. NETTING

A final issue in the conceptualization of the plaintiff's harm concerns netting. Should the plaintiff's losses be measured on a transaction-by-transaction basis, or is it appropriate for the court to aggregate multiple transactions?[244] Many investors, especially institutions, engage in multiple trades during the class period. Some of these transactions result in gains, some in losses. Some transactions involve securities purchased during the class period and sold afterwards, and some involve previously purchased securities that are sold during the class period. Which transactions should be taken into account in determining the extent of the plaintiff's harm?[245]

Some courts have held that the plaintiff's recoverable damages should be measured by netting trading gains and losses.[246] The Supreme Court in *Randall*, although rejecting the idea that the plaintiff's tax benefits should be offset against rescissionary damages, suggested that such an offset would be proper when damages were based on out-of-pocket losses.[247] Netting is also consistent with *Dura*'s statement that a plaintiff's purchase at an artificially inflated price can be offset by a subsequent sale at the inflated price.[248] This damage calculation views the plaintiff as obtaining a benefit from the sale that must be offset against the plaintiff's initial loss. Until the stock price drops, the plaintiff can potentially receive this benefit. Only when the possibility of netting is lost has the plaintiff been injured.

Other courts have rejected netting in favor of a transaction-by-transaction analysis. For example, the court in *Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.* refused to aggregate multiple transactions, arguing that aggregation is both inconsistent with the statutory language and difficult to apply in a principled manner.[249] To date, the issue remains unresolved. As the court stated in *In re CIGNA Corp. Securities*

244. A natural extension of this inquiry would require the court to consider whether a plaintiff's net economic position has been affected by hedging, options positions, derivatives trading, etc.

245. Netting raises additional issues such as the method for determining the cost basis of the securities in question and whether holdings in separate accounts or funds should be aggregated. *See In re* CIGNA Corp. Sec. Litig., 459 F. Supp. 2d 338, 343–44 (E.D. Pa. 2006) (considering whether an institutional investor's purchases of CIGNA stock in separate accounts managed by separate managers should be aggregated for the purpose of calculating the investor's loss).

246. *See, e.g.*, *In re* Comdisco Sec. Litig., 150 F. Supp. 2d 943, 945 (N.D. Ill. 2001) (describing the plaintiff's transaction-based claim of losses as "a mirage"); *see also In re* eSpeed, Inc. Sec. Litig., 232 F.R.D. 95, 101 (S.D.N.Y. 2005) (rejecting one lead plaintiff applicant in favor of another because the first applicant's losses "were actually somewhat cushioned by the sales made when [the defendant's] stock price was high").

247. *See* Randall v. Loftsgaarden, 478 U.S. 647, 662–63 (1986) (distinguishing the rescission remedy from the attempt to calculate the plaintiff's net economic harm).

248. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005).

249. *See* Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp., 315 F. Supp. 2d 666, 679–81 (E.D. Pa. 2004).

Litigation: "[T]here is nothing in *Dura Pharmaceuticals* that explicitly holds that (a) an investor who suffers damages from specifically identified transactions cannot recover losses from those transactions, or (b) that investor's other trading in the company's stock is relevant to a claim for damages based on the isolated transactions."[250]

Here again, traditional tort principles offer some guidance. Tort law typically does not net the plaintiff's losses and benefits from wrongful conduct in determining recoverable damages. Tort theorists and philosophers have offered a variety of analytical approaches to explain this result. For example, commentators at a *San Diego Law Review* symposium discussed a hypothetical in which the plaintiff's leg is broken as a result of the defendant's negligence; because of the accident, the plaintiff fails to get on an airplane that subsequently crashes.[251] The defendant's negligence is a but-for cause of both the plaintiff's harm—the broken leg—and the plaintiff's benefit—the failure to die in the plane crash. Should a court net the harm against the benefit?[252]

Although tort law generally does not net the harm and the benefit, or even consider evidence of the beneficial effects of the defendant's tortious conduct, one might argue that it could do so as long as the relationship between the harm and the benefit was sufficiently close. In traditional tort terminology, one might argue that courts should net the benefit against the harm if the defendant's conduct proximately caused the plaintiff's benefit.[253] In the airplane example, a court would likely find the airplane crash too far removed from the initial accident.[254] In contrast, trading gains at the inflated price are closely related to the trading losses suffered by the plaintiff as a result of the misrepresentation. Thus, tort law offers a plausible argument in favor of evaluating the plaintiff's economic loss by aggregating multiple transactions.

250. *CIGNA*, 459 F. Supp. 2d at 354.

251. One can imagine referring to the defendant's conduct in this case as an example of an efficient tort, in the sense that it produces a net benefit for the plaintiff.

252. *See* Leo Katz, *What to Compensate? Some Surprisingly Unappreciated Reasons Why the Problem Is So Hard*, 40 SAN DIEGO L. REV. 1345, 1347 (2003) (discussing counterfactual and causal approaches to the analysis); Stephen Perry, *Harm, History, and Counterfactuals*, 40 SAN DIEGO L. REV. 1283, 1312–13 (2003) (opining, based on the equities of the scenario, that there should be no offset, but admitting that "respectable argument[s]" support the opposite conclusion).

253. *See* Perry, *supra* note 252, at 1313 ("The [airplane hypothetical] is reminiscent . . . of the coincidence cases that arise under the rubric of proximate cause. . . . The coincidence rules out liability in such . . . case[s], and my sense is that it should similarly rule out offset in the case of the doomed airplane.").

254. *See id.* (reaching this conclusion). Similarly, if the delay occasioned by the defendant's conduct caused the plaintiff to take a later, crashing flight after missing his original, non-crashing flight, courts would likely find that the plaintiff's death was not a foreseeable consequence of the wrongful conduct and, therefore, that proximate cause was lacking.

V. CAUSATION AND FEDERAL SECURITIES FRAUD

The foregoing analysis of harm has drawn heavily upon common law principles in the manner suggested by *Dura* but ignored by the majority of federal courts. This Article demonstrates that despite the claim that causation in securities fraud is modeled on common law tort principles, the lower courts have not been faithful to this claim and have either ignored or misapplied important common law guidance on the meaning of proximate cause, the role of intervening cause, and the legal effect of multiple or indeterminate causation. Despite *Dura*'s instruction, cases like *Oscar* move securities fraud further away from common law tort, at least with respect to causation analysis. At the same time, the analysis in Part III indicates that tort law is not a panacea; applying tort law principles is neither easy nor necessarily determinate. Indeed, an exploration of tort law suggests that *Dura*'s incorporation of tort law principles is somewhat disingenuous.

Dura's legacy regarding the requirement of economic harm is another failure. Although the lower courts, following *Dura*, now insist that a plaintiff allege "economic harm," as the *CIGNA* court observed, subsequent rulings have failed to explain what that concept means.[255] The result has been a series of conflicting and confusing cases untethered to an anchoring principle about the type of injury for which protection is warranted. Common law tort law offers tools for conceptualizing the harm, and Part IV considered different ways to define the harm in securities fraud litigation using these tools. The common law methodology demonstrates, however, that recoverable harm is a legal construct. Part IV identified several alternatives, but the choice among these alternatives depends on policy considerations and regulatory objectives. This Part now considers this choice in light of current policy debates about the proper role of private securities fraud litigation.

A. SECURITIES FRAUD AND TORT LAW

At first glance, the analogy to common law fraud and deceit suggested by *Dura* appears to work fairly well. Private litigation protects investors' reliance interests by allowing them to recover when they have been misled by false information. A private right of action increases market efficiency by creating an incentive for investors to read federally mandated disclosures and by imposing liability on defendants who do not prepare those disclosures carefully. A damage remedy compensates investors not just for a decline in the value of their investments but also for the impairment of their investment decisions. Because investors are largely repeat players, interfering with their ability to research investments and rely on information

255. *CIGNA*, 459 F. Supp. 2d at 353 ("To date, no Court of Appeals has ruled on the impact of *Dura Pharmaceuticals* on the establishment of economic loss and damages for purposes of proof at trial.").

disseminated into the marketplace creates a broader harm than that captured through a stock price decline. That harm is consistent with the broader measures of damages reflected in fraud law, including recovery for all foreseeable damages that were a factual result of the initial investment decision. The reliance requirement establishes the critical causal link between the defendant's misconduct and these damages. Additionally, as in common law fraud, overdeterrence in securities fraud is not a significant concern because the wrongful conduct is intentional, not merely negligent.

Structural considerations relating to the appropriate scope of judicial lawmaking also counsel in favor of drawing upon common law fraud. Although securities fraud is a statutory claim, it is an implied private right of action based upon a bare-bones statute that offers little guidance as to its appropriate scope or objectives. Determining the contours of the private right of action and fashioning the elements of the claim have been the work of the federal courts. Commentators have described this process as akin to common law lawmaking.[256] Accordingly, tethering the scope of the claim to an established common law claim reduces the broad policymaking discretion of the federal courts and is consistent both with current approaches to statutory interpretation that seek to minimize such discretion and with *Erie* principles.[257]

The Court's decision in *Basic* critically changes this analysis. By eliminating the requirement that plaintiffs prove reliance on misrepresentations, *Basic* destroys the component of the transaction that would establish causation under common law fraud principles.[258] The *Basic* presumption has the practical effect of eliminating the requirement of a causal relationship—at the purchasing stage—between the defendant's conduct and any subsequent harm. The impairment of the investment decision that occurs in a traditional fraud context does not exist.

Basic replaces reliance on the misrepresentations with reliance on the market price. Under the view articulated in *Basic*, plaintiffs are harmed not because they were misled into purchasing but because they purchased at the "wrong" price.[259] The misinformation that the defendant imparted into the

256. *See, e.g.*, Edward A. Fallone, *Section 10(b) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. ILL. L. REV. 71, 95 (describing the private right of action for federal securities fraud as "largely the product of 'federal common law'").

257. *See* Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78 (1938) (rejecting the existence of a general federal common law).

258. *See In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 363 (S.D.N.Y. 2003) (distinguishing causation analysis in FOTM cases from causation analysis in cases involving face-to-face transactions and actual reliance), *aff'd sub nom.* Lentell v. Merrill Lynch & Co., 396 F.3d 161 (2d Cir. 2005).

259. *See* Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud-on-the-Market* 7–10 (Georgetown Univ. Law Ctr., Law & Econ. Research Series Paper No. 1026316, 2007), *available*

market distorted the market price and caused plaintiffs to overpay for the securities in question, but it did not directly affect their investment decisions. As Judge Sneed explained in *Green v. Occidental Petroleum Corp.*:

> The argument that but for the misrepresentation the stock would not have been purchased and that, as a consequence, all investment losses should be recoverable ignores the fact that the plaintiffs in this case relied not upon the misrepresentations themselves but merely on the assumption that the price of the stock was set by valid market conditions.[260]

The key consequence of *Basic* is that it changes the nature of the plaintiff's harm.[261] The damage that the defendant causes in an FOTM scenario is not the disruption of investment decisions or the sacrifice of investor confidence in the accuracy of financial documents—it is a distortion of the market price.[262] The defendant's actions result in a stock price effect, not a purchasing decision. As a result, it is illogical to define the plaintiff's harm in terms of a distorted decision or to measure harm by the consequences that flow from the purchasing decision. The only harm caused by the price distortion is the amount of the distortion; investors are buying at the "wrong" price.

Indeed, the investors who recover under *Basic* are largely investors for whom the rationale of protecting investment decisions makes no sense. FOTM plaintiffs do not enhance market efficiency by reading disclosures and incorporating them into investment decisions. For many such investors, issuer-specific information is not only ignored, it is irrelevant to the investment decision. Index investors, for example, purchase on the basis that a stock is part of a particular index, not on an assessment of the quality of the investment or even on a judgment that the stock is currently trading at a fair price. For these investors, it is simply a matter of happenstance that the stock price turns out, in retrospect, to have been wrong. A securities

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at http://ssrn.com/abstract=1026316 (offering various explanations of the connection between distortion of market price and investor reliance).

260. Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1343 n.3 (9th Cir. 1976) (Sneed, J., concurring in part and concurring in the result in part).

261. *See* Basic Inc. v. Levinson, 485 U.S. 224, 254 n.5 (1988) (White, J., concurring in part and dissenting in part) (criticizing the majority for declining to address the "difficult damages question" created by the Court's acceptance of FOTM theory).

262. An alternative justification for the outcome in *Basic* is to conclude that the plaintiffs' injury resulted from the fact that third parties—those who read the misrepresentations and relied upon them to affect market prices—were defrauded. *But cf.* Holmes v. Sec. Investor Prot. Corp., 503 U.S. 258, 268–69 (1992) (noting the historical rejection of this argument in analyzing proximate cause under the federal RICO statute). This justification may be consistent with market realities and, if extended, offers a basis for upholding liability in *Stoneridge* as well. It is not, however, consistent with either the language of the *Basic* decision or the scope of existing tort law.

fraud recovery amounts to a type of insurance for the fraud premium that the investors have paid.

Under this analysis, the plaintiff's recovery must necessarily be limited. At a minimum, recovery should be limited to the amount by which the price is distorted. FOTM leaves no room for expectation damages because the plaintiff had no expectation, or at least none that the fraud affected.[263] Similarly, no logical connection exists between the plaintiff's initial overpayment and subsequent events that affect the value of the security. Because the plaintiff was not deceived into purchasing, *Basic* breaks the causal link between the fraud and subsequent stock price drops that are due to market and other forces. Finally, conceiving of securities fraud recoveries as a type of insurance offers a justification for limiting recovery to those who suffer a net loss and excluding those investors who realize an aggregate gain as well as transactions in which the stock price exceeds the initial purchase price. If a plaintiff's overpayment is a matter of happenstance, there is no reason to ignore happenstance developments that reduce or eliminate the investment effect of that overpayment.[264]

Importantly, however, these moves are justified in FOTM cases by the fact that we are no longer dealing with a cause of action and a resulting type of harm that are analogous to common law fraud. If *Basic* transformed securities fraud into a distinct statutory claim, with a different scope and different objectives, the rationale behind the common law analogy is not compelling. There is no reason to believe that common law principles can or should be transferred uncritically to the transactional context of the global securities markets.[265] Similarly, the *Basic* transformation may not require a rejection of common law principles in traditional reliance-type securities fraud cases. Although these cases have largely been eclipsed by *Basic* and its progeny,[266] some recent decisions have applied *Dura* principles

263. As Judge Sneed explained, all that the plaintiffs were ever entitled to was "a price set by valid market forces unrelated to the misrepresentations." *Green*, 541 F.2d at 1343 n.3 (Sneed, J., concurring in part and concurring in the result in part).

264. *Cf.* Kenneth S. Abraham & Kyle D. Logue, *The Genie and the Bottle: Collateral Sources Under the September 11th Victim Compensation Fund*, 53 DEPAUL L. REV. 591, 601–06 (2003) (describing various methods of preventing overcompensation of tort victims who have insurance coverage).

265. *But see* Moore v. PaineWebber, Inc., 189 F.3d 165, 176 (2d Cir. 1999) (Calabresi, J., concurring) (examining the causation requirement in RICO fraud by analogizing to the destruction of cabbages on the way to market).

266. *See* McCabe v. Ernst & Young, LLP, 494 F.3d 418, 425 (3d Cir. 2007) (describing reliance-based, non-FOTM cases as "non-typical § 10(b) actions").

of loss causation beyond the FOTM context.[267] It is not clear that this approach is justified.[268]

B. The Appropriate Scope of the Statutory Fraud Remedy

As the Supreme Court observed in *Blue Chip Stamps v. Manor Drug Stores*: "[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable."[269] The *Schlick* court itself—the source of the causation requirement in federal securities fraud[270]—explicitly distinguished the causation element from its tort law predecessor, observing that the statutory cause of action implicated distinct policy considerations.[271] If common law fraud principles do not dictate how to resolve questions of causation and harm in the context of a 10b-5 claim, what factors should the courts consider?

A starting point in this analysis is the extensive policy debate over the value of a private right of action for federal securities fraud.[272] Most commentators identify the objectives of private securities fraud litigation as victim compensation and deterrence of wrongful conduct, objectives that are modeled on those of tort law.[273] A substantial number of scholars, however, have questioned the extent to which private litigation is effective in achieving either goal.[274]

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267. *See id.* at 433 (acknowledging that *Dura* is not controlling outside the FOTM context, but stating that "we believe the logic of *Dura* is persuasive").

268. *See, e.g.*, Livid Holdings Ltd. v. Salomon Smith Barney, Inc., 416 F.3d 940, 949 n.2 (9th Cir. 2005) (stating that "*Dura* is not controlling" in non-FOTM, reliance-based cases).

269. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744–45 (1975).

270. *See supra* notes 15–22 and accompanying text (discussing *Schlick*).

271. Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 383 (2d Cir. 1974). When appropriate, courts have recognized differences between the elements of federal securities fraud and those of the common law. The most commonly cited example is the elimination of the requirement of privity. *See* 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 7:259, at 7-416 (2d ed. 2008) ("The common law requirement of privity has all but disappeared from 10b-5 proceedings." (citation omitted)).

272. As then-Professor, and now-Judge, Guido Calabresi observed some years ago, formulating the scope of causation analysis depends critically upon identification of the "goals or functions" of the law. Calabresi, *supra* note 114, at 73 (describing cause as a "functional concept"). This Part considers causation in securities litigation within a similar functional context.

273. *See, e.g.*, John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1538 (2006) ("From a policy perspective, the securities class action has two potential rationales: compensation and deterrence."); *see also* James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 509–15 (1997) (defending securities fraud litigation as furthering both objectives).

274. *See, e.g.*, Coffee, *supra* note 273, at 1545–56 (identifying failures to achieve either compensation or deterrence objectives); *see also* Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, LAW & CONTEMP. PROBS., Autumn 1997, at 167, 174–75 (describing the

Although the arguments are too extensive to review in detail, commentators have argued that securities fraud litigation is ineffective in deterring wrongful conduct largely because, almost invariably, the damages are paid by the defendant corporation (and thus indirectly by its shareholders and insurance company) rather than by the individual corporate officials who made the fraudulent statements.[275] The current structure of director and officer insurance policies,[276] the corporate structure in which the knowledge and conduct associated with securities fraud may be spread among a number of officials, and the limited financial resources of corporate officials (compared to the corporation itself) make it very difficult to recover damages from individual wrongdoers. Moreover, when misstatements are made in connection with secondary market trading, the corporation does not benefit from the fraud and may even be a victim in the sense that corporate officers may manipulate financial reporting in order to increase their personal compensation or limit their accountability for poor corporate performance.

Some scholars have gone further and argued that courts may not impose fraud sanctions accurately, leading to payouts in cases that do not involve misconduct while enabling some wrongdoers to escape liability.[277] To the extent that factors other than the merits—such as the size of the stock price drop or the company's market capitalization—influence the likelihood of a lawsuit, the deterrent effect of litigation is further reduced. The courts have also expressed concern about the *in terrorem* effect of securities fraud class actions. The exposure to potentially large liability—or even significant litigation costs—may increase the pressure to settle weak cases.[278]

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trend to characterize deterrence, rather than compensation, as the primary objective of securities fraud litigation); Pritchard, *supra* note 37, at 945–47 (arguing that deterrence, rather than compensation, should be the primary goal of securities fraud litigation).

275. *See, e.g.*, Coffee, *supra* note 273, at 1549–53 (describing who bears the costs of securities class actions).

276. *See, e.g.*, Terrence G. Stolly, Comment, *Scienter Under the Private Securities Litigation Reform Act of 1995: Unexpected Implications on Director and Officer Liability and D&O Insurance*, 29 CAP. U. L. REV. 545, 584–86 (2001) (describing how the fraud exclusion in many D&O policies makes it difficult to recover against corporate officials for securities fraud).

277. *See, e.g.*, A.C. Pritchard, Stoneridge Investment Partners v. Scientific-Atlanta*: The Political Economy of Securities Class Action Reform*, 2007–2008 CATO SUP. CT. REV. 217, 225 ("Courts and jurors, with hindsight, may have difficulty distinguishing false statements (which were known to be false at the time) from unfortunate business decisions.").

278. *See, e.g.*, Janas v. McCracken (*In re* Silicon Graphics Inc. Sec. Litig.), 183 F.3d 970, 978 (9th Cir. 1999) (noting that Congress enacted the PSLRA in part to prevent abusive securities fraud class actions designed "'to impose costs so burdensome that it [was] often economical for the victimized party to settle'" (alteration in original) (quoting H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730)). It is unclear whether this concern is warranted in light of the substantial barriers to litigation adopted by the PSLRA and decisions such as *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), *Dura*, and *Stoneridge*.

There is some empirical evidence supporting criticisms of the deterrent effect of private litigation. In particular, although scholars have found that corporate officers and directors suffer substantial reputational damage and other penalties associated with government enforcement actions for securities fraud, they have not found similar effects for private litigation.[279]

Securities fraud litigation also presents a risk of overdeterrence, a risk that increases to the extent that settlement pressure and other factors reduce the accuracy with which sanctions are imposed. Although courts cannot impose liability unless the plaintiff proves scienter, the scienter requirement is substantially watered down from the common law requirement of intentional misconduct and often involves little more than gross negligence.[280] As a result, common law fraud's lack of concern for excessively deterring intentional misconduct is inapposite. Indeed, private litigation can deter corporate officials from disclosing information because of liability concerns. This chilling effect may reduce market efficiency.

Commentators have questioned the compensation objective even more harshly. Here, there are two main arguments. First, securities fraud cases typically settle for a small percentage of the claimed damages.[281] As a result, commentators argue that investors' losses are largely uncompensated. The problem with this argument is that it does not address the question of what portion of the loss is compensable. If a recovery is compared to the gross amount of a stock price drop, it is likely to reflect only a portion of that drop. Under the reasoning discussed above, however, the full amount of the drop may not constitute recoverable harm. The second argument about

279. *Compare* Jonathan M. Karpoff et al., *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 193, 194 (2008) (reporting that 93% of officers and directors responsible for securities fraud lost their jobs, and describing other penalties suffered by culpable managers, including fines and criminal prosecution), *with* Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation*, 49 J.L. & ECON. 365, 366 (2006) (finding little evidence that officers and directors suffer a reputational penalty from private litigation against their companies).

280. Courts have generally interpreted the scienter requirement to require some level of reckless conduct. *See, e.g.*, Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 343 (4th Cir. 2003) ("[E]very circuit that has considered the issue has held that scienter may . . . be established by a showing of recklessness."). Congress imposed a heightened pleading standard in the PSLRA. *See Tellabs*, 127 S. Ct. at 2509 (interpreting the requirement that the plaintiff allege facts supporting a "strong inference" of scienter). The PSLRA did not, however, address the scienter requirement itself. *See id.* at 2507 n.3 ("The question whether and when recklessness satisfies the scienter requirement is not presented in this case.").

281. *See, e.g.*, TODD FOSTER ET AL., RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: FILINGS STAY LOW AND AVERAGE SETTLEMENTS STAY HIGH—BUT ARE THESE TRENDS REVERSING? 12 (2007), *available at* http://www.nera.com/image/PUB_RecentTrends_Sep2007_2color_web-FINAL.pdf (reporting that from 2002 through 2007, the annual median ratio of settlement to investor losses ranged from 2.1% to 3.0%).

compensation involves the "circularity problem."[282] Because damages are paid almost exclusively by issuers, current shareholders bear the cost.[283] A diversified investor is as likely to be a current shareholder who pays as a former shareholder who recovers.[284] Over time, the gains and losses from litigation should balance out, leaving diversified investors no better off than if the litigation had not occurred (and worse off after subtracting the transaction costs of litigation, including legal fees).[285] Some commentators have further argued that, to the extent undiversified investors suffer disproportionately large losses, the law should not protect them from irrationally failing to protect themselves through diversification.[286]

A partial answer to the circularity argument is the insurance analogy. To the extent that fraud recoveries function as a type of investor insurance, the goal is to spread losses among investors, and investors would expect to come out even, on the average. This Article argued in Part IV that *Basic* had the effect of shifting securities fraud recoveries from a tort-like remedy for misplaced reliance to a type of insurance or cost-spreading for transactions effected at a distorted price.[287] The conception of Rule 10b-5 as an insurance scheme has been greeted with open hostility by courts and commentators.[288] Yet, at the core, the unarticulated question over the extent to which an insurance-type scheme is warranted may be at the heart of the debate over private litigation.

It is important here to distinguish between insurance for investment losses and insurance for losses resulting from fraud. No one is suggesting that investors should be able to recover under Rule 10b-5 for all securities losses. Indeed, the courts' post-*Basic* expansion of the loss causation requirement might be seen as an effort to tailor appropriately the insurance

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282. *See* Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. (forthcoming 2009) (manuscript at 4, on file with the Iowa Law Review) (describing the "circularity problem").

283. *Id.*

284. *Id.*

285. *Id.*

286. *See, e.g.*, Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 13 (2007) ("The law should presume that a reasonable investor is a diversified investor.").

287. *See, e.g.*, Calabresi, *supra* note 114, at 73–74 (identifying cost-spreading as a goal of tort law but arguing that "causal linkage is irrelevant to the spreading function of tort law"). This observation may, in part, have motivated the Court's decision in *Basic*.

288. *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 252 (1988) (White, J., concurring in part and dissenting in part) (expressing concern that an irrebuttable presumption of reliance would "convert Rule 10b-5 into 'a scheme of investor's insurance'" (quoting Shores v. Sklar, 647 F.2d 462, 469 n.5 (5th Cir. 1981))); Julie A. Herzog, *Fraud Created the Market: An Unwise and Unwarranted Extension of Section 10(b) and Rule 10b-5*, 63 GEO. WASH. L. REV. 359, 362 (1995) ("Proof of reliance is necessary to avoid turning the rule into a 'scheme of investor's insurance' or a mechanism for recovery of losses whenever an investment turns sour." (footnote omitted) (quoting List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965))).

remedy provided by *Basic*. In order to prevent Rule 10b-5 from turning into an insurance system for market-based losses, those losses must be removed from the calculation of the plaintiff's damages. Moreover, to the extent that an FOTM recovery is based on mispricing, investors presumably have priced the risk of nontortious causes of a price decline into their ex ante investment decisions. Compensating investors for the materialization of those risks amounts to a windfall.

Whether a narrower type of insurance for fraud-based losses is desirable depends on several factors. First, a critical distinction between securities fraud and the harms commonly covered by insurance is that securities fraud produces, in every case, winners and losers. Investors who purchase at the inflated price suffer harms; investors who sell at the inflated price receive a windfall gain. When misinformation distorts the market, it may do so largely in an unbiased manner in the sense that individual investors are equally likely to win or lose from the presence of fraud in the market.[289] If this is true, investors are unlikely to discount for the risk of fraud. This would undermine the argument that fraud inflicts a systematic harm on the market by increasing the cost of capital.[290] Alternatively, it is possible that some investors may lose more frequently than others.[291] Insiders may knowingly sell when the market price is inflated, as Ken Lay allegedly did in Enron.[292] Indexed investors, because of the manner in which they trade, may be more likely to purchase overvalued securities. The distribution of losses and gains is thus critical to assessing the social cost of securities fraud.

This leads to the second factor. It would be helpful to know not just who loses money but also who recovers in securities fraud litigation and how much. The answer to this question requires an exploration of the claims administration process. Several private organizations currently administer securities fraud claims. After the court approves a settlement, the claims administrator, which is typically selected by plaintiffs' counsel, notifies class members, receives and reviews claims, and pays out the settlement proceeds.

Although claims administrators report to the court the aggregate amount of damages paid, the administration process is opaque. Claims administrators do not report or publicly release data concerning the percentage of claims that are accepted versus rejected, the breakdown of

289. *See* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1021 (1992).

290. *See id.* at 1017–21 (categorizing different types of stock price inaccuracies and arguing that the extent of "loss of liquidity" costs depends on the type of inaccuracy involved).

291. *See id.* at 1018 (describing how uninformed investors are at a disadvantage relative to investors who possess undisclosed information).

292. *See* Daniel T. Ostas, *When Fraud Pays: Executive Self-Dealing and the Failure of Self-Restraint*, 44 AM. BUS. L.J. 571, 588–89 (2007) (describing allegations of a class action complaint that "twenty-nine Enron insiders consummated $1.1 billion in illegal trades . . . [by taking] advantage of artificially high stock prices caused, in part, by fraudulent financial reports" and that Ken Lay alone "cashed in for $101.3 million").

claims among small and large investors, or even the mechanisms used to resolve issues like netting and the existence of multiple investor funds or accounts in determining the investors' total loss. This data is critical for policymakers to debate meaningfully the value of fraud-based insurance as a mechanism for investor compensation. Similarly, this data should be evaluated in the context of meaningful information about investors' recoverable losses. Because loss causation is now fully litigated at early stages of the case, both plaintiffs' and defendants' counsel obtain expert reports that calculate recoverable damages, attempt to eliminate other causal factors, and quantify the amount of fraud-based harm. Parties do not release these calculations to investors or the public, making it impossible to evaluate the investors' actual recovery against their potential recovery on a per-share basis. Unless and until policymakers are able to determine who recovers and how much they recover, they cannot evaluate whether existing class actions provide meaningful compensation.

A third factor to consider is the availability of alternatives. Institutional investors hold an increasingly significant percentage of U.S. equities, and these institutions—largely as a result of the PSLRA—have become active in securities fraud litigation. One of the consequences of this involvement has been the decision by some institutions to opt out of class actions in favor of pursuing individual claims.[293] Opting out offers several advantages to an institutional investor. Although the settlement terms of most opt-out cases are confidential, media reports suggest that institutions sometimes recover more money and receive that money more quickly by opting out.[294] Individual claims are also not subject to many of the procedural barriers established by the PSLRA.[295]

Policymakers must weigh two conflicting implications of the opt-out option. On the one hand, the ability of institutional investors to pursue individual claims reduces the deterrence justification for the *Basic* decision.

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293. *See, e.g.*, Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 331 tbl.3 (2008) (reporting that 60% of public pension funds surveyed had opted out of representative securities litigation in favor of an individual action on at least one occasion); Keith L. Johnson, *Opting Out of Class Actions*, SEC. CLASS ACTION SERVICES ALERT, Jan. 2007, *available at* http://www.reinhartinvestor.com/WebAdmin/Files/optingoutofclassactions.pdf (describing the opt-out process).

294. *See, e.g.*, Gilbert Chan, *CalPERS' Time Strategy Pays Off: The State Pension Fund Gets $117.7 Million After Opting Out of Class-Action Suit Against Media Giant*, SACRAMENTO BEE, Mar. 15, 2007, at D4 (reporting that by opting out, CalPERS received a recovery in Time Warner litigation that was seventeen times what it would have received by remaining as a member of the class action); Neil L. Selinger, *Why Funds Opt Out of Class Action*, PENSIONS & INVESTMENTS, Feb. 20, 2006, at 12 (stating that opting out can lead to "substantial premiums over the class recovery" and "an expeditious payment"); Lorraine Woellert, *Fractured Class Actions: "Opt-Outs" Are a Growing Headache for Companies*, BUS. WK., Feb. 27, 2006, at 31 (noting recoveries by opt-out plaintiffs against Time Warner, WorldCom, and other big securities fraud defendants).

295. The provisions of the PSLRA apply to class actions. 15 U.S.C. § 78u-4(a)(1) (2000).

If large investors can bring suit and recover substantial damages in strong cases of fraud, class actions are not necessary to assure accountability. Institutions' large stakes will assure adequate damage claims to provide the necessary incentives for plaintiffs' counsel, and if they do not, the use of a broader conception of harm can augment damages in reliance-based cases. Moreover, the availability of private individual litigation likely operates as a sufficient safeguard against the possibility that regulators will lack the funding or political will to undertake sufficient enforcement efforts.

On the other hand, opting out may secure for institutions the majority of the recovery, reducing the potential compensation for retail investors even further. If sophisticated investors with large stakes pursue separate lawsuits, plaintiff classes will lose the benefit of the lead plaintiff provision, including the potential ability of active institutions to increase recoveries and reduce legal fees.[296] Issuers will also become unwilling to agree to large settlements in class actions if they face substantial additional exposure in opt-out cases. Thus, if the practice of opting out becomes sufficiently widespread, it could threaten the viability of the class action mechanism.

A stringent causation requirement exacerbates the problem. Institutional investors may not need the *Basic* presumption if they can prove reliance directly, and the extent to which *Dura*'s rigorous loss causation requirement applies in a reliance-based case is unclear. The result may well be a return to a pre-*Basic* world in which large investors can pursue individual securities fraud claims, and small investors are left without any recovery. Of course, the extent to which this constitutes a change from current practice is unclear. It may well be that small investors do not recover anything under current law due to the difficulties of submitting proof of their claim. Institutions, in contrast, are able to outsource the filing of their claims, making them more likely to recover.[297]

A final consideration in the debate over fraud insurance is the extent to which the circularity claim is accurate.[298] Although many commentators claim that a given investor is equally likely to pay or recover damages for securities fraud, in truth, the likely winners and losers are two distinct sets of investors. Securities fraud damages are recovered primarily by frequent traders, because it is necessary to purchase or sell securities in order to have

296. For statistics concerning the lead plaintiff provision and the involvement of institutional investors, see generally Stephen J. Choi et al., *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869 (2005); James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587 (2006).

297. *See* Choi & Fisch, *supra* note 293, at 332–33 (describing the outsourcing of claims filing by public pension funds).

298. *See, e.g.*, Fisch, *supra* note 282 (manuscript at 10–12) (arguing, in response to circularity arguments, that because reliance-based traders provide a positive governance externality, they should receive compensation for losses due to fraud).

standing under section 10(b).[299] Frequent traders are less likely to pay damages because they have often sold their stock by the time the company is held accountable for the fraud. Holders, current shareholders in the company, pay securities fraud damages, and those holders are disproportionately buy-and-hold investors. If securities fraud recoveries largely transfer wealth from retail investors and retirement accounts to hedge funds, the preservation of a fraud-insurance remedy may appear less attractive.

The foregoing discussion does not offer a complete solution. Instead, it demonstrates that the analysis of causation and damages for federal securities fraud must depend, in large part, on normative judgments. The factors identified above are among those that policymakers—legislators, regulators, or courts—should consider in determining the appropriate scope of the private right of action. As indicated, these judgments would also benefit from more complete data about current recoveries and payouts.

What, then, is the lesson from tort law? The *Dura* Court was right in instructing courts to look to the common law, because the common law of torts reflects a long history of adapting legal requirements to reflect policy considerations. This history stretches from the "two fires" cases to *Sindell* and the lost-chance doctrine. But the Court in *Stoneridge* was also right to counsel caution in importing tort law's requirements into Rule 10b-5 cases. Securities fraud and common law fraud differ, and to the extent that courts recognize and reinforce those differences, they enhance the ability of private litigation to address the demands of the global capital markets.

VI. CONCLUSION

Causation analysis has become one of the most complicated aspects of private federal securities fraud litigation. The courts have struggled to fashion a causation requirement, demonstrating relatively little understanding of the goals of the causation inquiry and of the nature of the harm to which the inquiry should be addressed. Although the Supreme Court determined that lower courts should use tort law principles in formulating an approach to causation, to date, the lower courts have failed in their efforts to do so. The result is a series of decisions that are inconsistent, unfaithful to the common law, and largely incoherent.

This Article traces the source of the problem to the Supreme Court's decision in *Basic*. By moving away from traditional reliance to stock price distortion as a description of the plaintiff's harm, *Basic* changed the nature of the private securities fraud claim. In particular, the *Basic*-generated statutory injury was a harm of potentially limitless proportions.

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299. *See* 15 U.S.C. § 78j(b) (2000) (prohibiting deception that occurs "in connection with the purchase or sale of any security"); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731–49 (1975) (recognizing this standing limitation).

The objectives of this statutory cause of action need not mirror those of traditional tort law, but to the extent that they do not, the scope of the claim must be tailored to address the underlying policy considerations. Identifying those policy considerations and formulating a conception of recoverable harm that accomplishes the desired objectives are approaches that the common law courts have applied in their development of tort law. It is this—and not tort law's definition of proximate cause—that is common law's lesson. In applying *Dura*, it is a mistake to look to common law cases involving squibs and cabbage carts. Although modern torts cases remain true to historic common law principles, they apply those principles in a context reflecting legal, policy, and scientific developments. To borrow from the common law, federal courts must incorporate these developments as well.