

***Damages In Securities Fraud Cases:  
Why Courts May Be Moving Away From An Approach That  
Measures Damages In Percentage Terms***

by

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Over the last several years, a debate has quietly been raging between plaintiffs and defendants—and their respective econometric experts—about how to properly calculate damages in securities fraud cases arising under Section 10(b) of the Securities Exchange Act of 1934. Two of the principal methods for doing so are the “constant percentage” method and the “constant dollar” method. As the names suggest, the constant percentage method measures “inflation” caused by fraud as a constant percentage of stock price throughout the class period, while the constant dollar approach measures “inflation” as a constant dollar amount of stock price.

The two approaches can result in dramatically different damages calculations. When the price of a company’s stock is declining during the class period—a scenario that is very typical in securities fraud cases—the constant percentage method will generally result in significantly greater per share damages figures than the constant dollar approach. Perhaps not surprisingly, the constant percentage tends to be the method of choice for plaintiffs, while defendants principally rely on the constant dollar approach.

While plaintiffs and defendants jostled over these two methodologies, the courts stood by largely silent on the issue. That remained the case until the U.S. District Court for the Northern District of Oklahoma—a district not necessarily known for being a “hotbed” for securities law

jurisprudence—tackled the debate head-on in the *In re Williams Securities Litigation* matter. In excluding the damages and loss causation report of plaintiffs’ expert, the *Williams* court found that the constant percentage method was in direct conflict with *Dura Pharmaceuticals, Inc. v. Broudo*, the controlling Supreme Court precedent on loss causation. Securities litigators and their experts should pay heed to *Williams*. To the extent that this well-reasoned decision starts a trend in the case law, use of the constant percentage method in securities fraud cases may become a thing of the past.

**The Debate: The “Constant Percentage” Method  
vs. The “Constant Dollar” Method**

Damages in Section 10(b) cases are premised on the notion that, during the class period, the company’s stock is artificially “inflated” due to a material misstatement or omission, and the inflation is then removed when the truth is disclosed to the market and the stock price declines. The idea is that investors who purchased the stock during the class period paid an inflated amount because the market overvalued the shares due to false or omitted information, and then were damaged when the truth was revealed and the stock price drops.<sup>1</sup> The “inflation” on any given day in the class period is the difference between the actual stock price and the price the stock would have sold for absent the misstatement or omission, and damages for shareholders are calculated by measuring the difference between inflation at purchase and inflation at sale.<sup>2</sup>

There are two principal approaches experts have used to measure the inflation—measuring it as a constant percentage of stock price (the “constant

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## Securities Reform Act Litigation Reporter

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percentage” method), or measuring it as a constant dollar amount of stock price (the “constant dollar” method).<sup>3</sup> The two approaches can lead to drastically different results.

The best way to understand the differences is through an example. Assume there are two investors, A and B. A purchases the stock of the company on Day 1 for \$200. B purchases the stock of the company on Day 2 for \$100 because the price has declined for reasons unrelated to the alleged fraud. On Day 3, the fraud is fully revealed by a corrective disclosure and the residual drop in the stock (in other words, the price drop after controlling for market, industry and other non-fraud influences in the price movement) is \$50. Because the full “truth” has been revealed as a result of the corrective disclosure on Day 3, the “inflation” at the end of Day 3 is now considered to be zero.

Using the constant dollar approach to measure fraud-based inflation in this scenario is relatively straightforward—it posits that the inflation is simply the amount of the residual price decline on Day 3, or \$50 in this example.<sup>4</sup> Thus, both A’s damages and B’s damages would be \$50 because that was the dollar decline “caused” by the disclosure of the revelation of the “truth.”

The constant percentage approach, on the other hand, would take the percentage decline of the residual drop—in percentage terms, the \$50 residual decline on Day 3 represents a 50% decline from the previous day’s price—and apply that percentage to the stock price throughout the entire class period. In our example, A and B would be considered to have purchased at the same inflation percentage (50%), but they would recover different dollar amounts because their purchase prices were different. A’s damages would be \$100 (50% of the \$200 purchase price), while B’s would be \$50 (50% of the \$100 purchase price). So in this example, use of the constant percentage approach increases A’s damages by \$50.

Importantly, this example—while overly simplistic—represents a common pattern in securities fraud cases. Indeed, as we saw with many of the securities fraud cases filed in connection with the bursting of the Internet bubble in the early 2000’s, there very often is a steady decline in the company’s stock before the “truth” of the fraud is disclosed through a corrective disclosure. When the price of the stock

is on a downward trend during the class period, the percentage method will generally result in a much larger per share damages figure than will the constant dollar method, as our example illustrates.

Proponents of the constant percentage method argue that, as a matter of economic theory, the market reacts to news in percentage, not dollar, terms.<sup>5</sup> Opponents, on the other hand, have principally launched a legal attack against the percentage method. Specifically, they have argued that the constant percentage method is inconsistent with the concept of loss causation because (i) it awards different damages to stockholders who suffered the same loss, and (ii) it posits that a shareholder may recover for a “loss” not associated with the fraud.

In our example, opponents of the constant percentage method would point out that not only does A get to recover damages (\$100) that are greater than B’s damages (\$50) even though they were exposed to the identical “fraud,” but that A’s damages are greater than the actual dollar drop associated with the full disclosure of the fraud (\$50). Given that damages for a shareholder are calculated as inflation on the day of purchase minus inflation on the day of sale, critics would also point out the fact that had Investor A sold the stock on *Day 2*—the day *before* the “truth” of the fraud was revealed—the constant percentage method would posit that A suffered a recoverable “loss” of \$50 because the dollar inflation on Day 1 (50% of \$200, or \$100) is \$50 greater than the dollar inflation on Day 2 (50% of \$100, or \$50). Critics would argue that this result is contrary to principles of loss causation because a loss that occurred before the fraud was revealed could not have been “caused” by the fraud.

### *Dura’s Impact On The Debate*

In *Dura Pharmaceuticals*, the United States Supreme Court addressed the pleading requirements for loss causation in securities fraud cases. The specific issue in *Dura* was whether merely pleading that the stock’s purchase price was inflated by fraud was sufficient to satisfy Section 10(b)’s requirement of loss causation, *i.e.*, that the alleged misrepresentation or omission “caused the loss for which the plaintiff seeks to recover.” 544 U.S. at 346 (citing 15 U.S.C. § 78u-4(b)(4)). The Supreme Court, reversing the Ninth Circuit’s decision, found that merely pleading an inflated purchase price was not enough to allege loss causation: “[A]n inflated

purchase price will not itself constitute or proximately cause the relevant economic loss.” *Id.* at 342.

The Court reasoned that, at the time an investor purchases a stock inflated by fraud, the investor has suffered no loss — “the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value.” *Id.* If the investor sells “the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss.” *Id.* Additionally, the Court noted that, even if a shareholder sold the stock at a loss after the “relevant truth” was revealed, the investor may not have suffered a *recoverable* loss under the securities laws because 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.” *Id.* at 343. The securities laws, held the High Court, were meant “not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.” *Id.* at 345. And a misrepresentation will “actually cause” a loss only when the “relevant truth” of that misrepresentation has been revealed, and where a plaintiff can show that the revelation itself — as opposed to other factors unrelated to the disclosure — resulted in the loss. *Id.*

Although the decision did not directly address damages calculations in securities fraud cases,<sup>6</sup> opponents of the percentage method seized on the Court’s discussion of loss causation principles to argue that the percentage method is an inappropriate method of measuring damages. Specifically, they have argued that the percentage approach is fundamentally inconsistent with the holding in *Dura* because it posits that a shareholder may suffer (and recover for) a “loss” that occurred before the “relevant truth” is revealed — a “loss” which, by definition, could not have been “actually caused” by the fraud.<sup>7</sup>

### The Williams Decision

Although the opponents of the constant percentage method viewed *Dura* as the proverbial nail in the coffin for the constant percentage method, courts still were reluctant to address the issue

head-on.<sup>8</sup> That changed in the *Williams Securities Litigation* case. See 496 F. Supp.2d 1195 (N.D. Okla. 2007). *Williams* was a Section 10(b) case brought by purchasers of securities issued by the Williams Communications Group, Inc., a company in the fiber optics business. The price of the company’s stock — like the stock of its competitors in the telecommunications industry at the time — was on a steady decline during the class period (July 2000-April 2002). Indeed, by the time of the first alleged corrective disclosure (January 29, 2002), the company’s stock price was only \$1.60.

Plaintiffs alleged that management of the company and the company’s auditors misrepresented the financial condition of the company. In support of their claims, plaintiffs submitted expert testimony on the issues of materiality, loss causation and damages. Defendants moved to exclude that testimony on the grounds that it did not pass muster under *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579 (1993). One of the damages scenarios (“Scenario 2”) set forth by plaintiffs’ expert was premised on the constant percentage method. Due to the fact that the stock was declining — indeed, was in a free fall — during the class period, the expert’s constant percentage model showed shareholders being damaged prior to the first alleged corrective disclosure.

Recognizing that this result would be in conflict with *Dura*’s holding that damages are not recoverable prior to the disclosure of the “relevant truth,” plaintiffs’ expert modified his constant percentage approach by only allowing damages to shareholders who held stock past the first corrective disclosure (identified by plaintiff as January 29, 2002). 496 F. Supp.2d at 1260. The court noted that, although the modification attempted to make the model *Dura*-compliant, it resulted in an internal inconsistency: “[Plaintiffs’ expert] acknowledged that he could give no ‘economic or logical reason’ why a shareholder who sold on January 29 would have a claim and a shareholder who sold on January 28 would not have a claim, explaining that [his damages] scenario 2 ‘was produced to meet some sort of legal definition of damages.’” *Id.*

Furthermore, the court noted that the constant percentage method, even with the plaintiffs’ expert’s proposed adjustment, resulted in a situation where an investor who sold her stock after the first corrective disclosure was recovering not just for

the “loss” caused by that corrective disclosure, but for “losses” suffered prior thereto (a period during which the entire telecommunications sector was suffering massive losses):

The result [of the percentage method]. . . is that a small loss in share value (on or after January 29) in dollar terms translates into a large dollar recovery per share for shares bought early in the class period—a recovery in dollars per share that is attributable mostly to share price declines that occurred *before* the first corrective disclosure.

*Id.*; see also *id.* at 1269 (“[U]nder [Damages] Scenario 2, an investor who sold on January 28, 2002 gets no recovery, while an investor who sold on January 29 recovers for all of his loss of per-share value *for the entire class period* (nearly \$ 25 per share for an investor who bought at the beginning of the class period), even though the price of the stock had already declined 94 percent, to \$ 1.60 before (as postulated in Scenario 2) ‘the relevant truth’ emerged.” (emphasis in original).

The court held that this result was incompatible with *Dura* because “a loss in value occurring before the first corrective disclosure ‘cannot be considered causally related to [defendant’s] fraudulent [conduct].’” *Id.* at 1269-70 (citation omitted). In the court’s view, “the application of the constant percentage inflation approach would give the equity

investor the ‘partial downside insurance policy’ which *Dura* counsels that the securities law should not provide.” *Id.* at 1270.<sup>9</sup>

Although the court noted in a footnote that it could “conceive of a case involving a short class” in which the constant percentage approach would “at least clear the *Daubert* hurdle,” it offered no real guidance as to when that approach would ever be appropriate. *Id.* at 1270, n.54. Indeed, the fundamental premise of the court’s ruling—that the constant percentage method is contrary to *Dura* because it allows for the recovery of damages not tied to the disclosure of the fraud—seems totally at odds with any application of the constant percentage method.<sup>10</sup>

## Conclusion

For critics of the constant percentage method, the *Williams* case did explicitly what the *Dura* case did implicitly—condemn the constant percentage method as being inconsistent with the principles of loss causation in a securities fraud case. Whether *Williams* starts a trend in the case law remains to be seen, but it certainly has the potential to be a watershed case on how damages are calculated in securities fraud cases.

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## Notes

<sup>1</sup> See David H. Topol, *Attacking Plaintiffs-Style Damages During Mediation of Securities Cases*, Professional Liability Underwriting Society Plus, May-June 2004.

<sup>2</sup> As discussed below, *Dura* now prohibits the recovery of damages for shares sold before the “relevant truth” is disclosed about the fraud. See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342-46 (2005). Additionally, damages in Section 10(b) cases are subject to the 90-day “look back” provision of the Private Securities Litigation Reform Act, which provides that “the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission

that is the basis for the action is disseminated to the market.” 15 U.S.C. § 78u-4(e).

<sup>3</sup> For a more expansive discussion of the methodologies for calculating damages in securities fraud cases (and an analysis of the impact of *Dura* and *Williams*), see David Tabak, *Inflation and Damages in a Post-Dura World*, (September 25, 2007), [http://www.nera.com/Publication.asp?p\\_ID=3287](http://www.nera.com/Publication.asp?p_ID=3287).

<sup>4</sup> This would be the commonly used “back-casting” method of measuring inflation, which determines inflation by measuring the price decline caused by the corrective disclosure, and applying that price decline—in dollar or percentage terms—throughout the entire class period. The less common “forward casting” approach, on the other hand, measures inflation by examining the stock price increase when the alleged misstatements/omissions

were originally made, not the decline when the “truth” was revealed through a corrective disclosure. See generally Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implication of Dura Pharmaceuticals v. Broudo*, The Harvard John M. Olin Discussion Paper Series 596 (August 2007), [http://www.law.harvard.edu/programs/olin\\_center/Ferrell\\_et%20al\\_596.pdf](http://www.law.harvard.edu/programs/olin_center/Ferrell_et%20al_596.pdf).

<sup>5</sup> See Daniel P. Lefler & Allan W. Kleidon, *Just How Much Damage Did Those Misrepresentations Actually Cause And To Whom?: Damages Measurement In “Fraud On The Market” Securities Class Actions*, 1505 PLI/Corp. 285, 295-296 (2005).

<sup>6</sup> The constant dollar vs. constant percentage issue was briefed in *Dura*, but the Court did not opine on the issue. See, e.g., Brief of Broadcom Corporation as Amicus Curiae in Support of Petitioners, 2004 WL 2075751, at \*10 (“Losses caused by a misrepresentation should be measured by the dollar decline when the market learns of a misrepresentation. Using the percent decline as opposed to the dollar decline leads to perverse results. . . . For example, the percent method can lead both to awards of damages to stockholders who suffered no losses caused by a misrepresentation and to different treatment of stockholders whose actual losses caused by a misrepresentation are the same.”).

<sup>7</sup> See, e.g., Lefler & Kleidon, *supra* n. 9.

<sup>8</sup> A number of post-*Dura* cases have held that damages may not be awarded for losses suffered prior to the revelation of the “truth” of the fraud—which can be interpreted as implicitly barring the constant percentage approach—but none has directly addressed the constant percentage vs. constant dollar debate. See generally *In re Daou Systems, Inc. Securities Litigation*, 411 F.3d 1006, 1026-1027 (9th Cir. 2005) (“We note that, as the [Third Amended Complaint] currently reads, at the time when Daou began to reveal its true financial health in August 1998, its stock was trading at \$18.50 per share and not at the class high of \$34.37. The [Complaint] does not allege any revelation of Daou’s true financial health prior to August 1998. Thus, as the [Complaint] reads now, any losses suffered between \$34.37 and \$18.50 cannot be causally related to Daou’s alleged fraudulent

accounting methods because before the revelations began in August 1998, the true nature of Daou’s financial condition had not yet been disclosed.”); *In re Redback Networks, Inc., Securities Litigation*, 2007 WL 963958, at \*6 (N.D. Cal. March 30, 2007) (“[T]he stock price began to fall in June 2001 when the ‘truth’ began coming out. However, at that time the stock *already had fallen to less than \$12 per share*. Based on Plaintiffs’ own allegations, the fall from \$150 to \$12 cannot be attributed to the alleged fraud.”) (emphasis in original).

<sup>9</sup> The court found that the expert’s other damages scenarios did “not square with the law of loss causation, applied through the prism of *Daubert* and Rule 702.” *Id.* at 1294. Finding no evidence of loss causation or damages, the court granted defendants summary judgment. *Id.* at 1295 (“[T]he summary judgment record provides no basis upon which a finder of fact could reasonably determine, consistent with loss causation doctrine established by *Dura* and its progeny, that plaintiffs’ claimed losses were caused by defendants’ alleged misrepresentations or omissions and not by ‘changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events’”) (citing *Dura*, 544 U.S. at 342-43).

<sup>10</sup> Tabak, *supra* n.3, notes that the constant percentage method may be adjusted to make the approach compliant with *Dura*, but notably, the suggested adjustments result in damages that are always less than or equal to what would be found under the constant dollar method.