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The Fraud on the Market Theory and Securities Fraud Claims

To maintain a claim for securities fraud, it is well established that a plaintiff must plead and prove both (i) that it relied upon defendant's allegedly fraudulent conduct in purchasing or selling securities, and (ii) that defendant's conduct caused, at least in part, plaintiff's loss. These two elements are generally known, respectively, as "transaction causation" and "loss causation."

The "fraud on the market theory," also well established, entitles plaintiffs to a rebuttable presumption of the existence of transaction causation (e.g., that they relied upon allegedly fraudulent information) even where they were unaware of the fraudulent conduct at the time of their purchase or sale.

Some plaintiffs, however, have sought to extend the fraud on the market theory to also enable them to establish loss causation — effectively relying upon the theory for "double duty" to satisfy both causation elements.

This approach has received greater attention following two recent decisions reaching opposite conclusions: the much-publicized *Merrill Lynch & Co. Research Reports Securities Litig.* decision,[1] in which a prominent district court rejected such an expansive application of the fraud on the market theory, and the *Broudo v. Dura Pharmaceuticals, Inc.* decision,[2] in which the U.S. Court of Appeals for the Ninth Circuit embraced this approach.

Merrill Lynch got it right and *Broudo* got it wrong. The fraud on the market theory should not be expanded to enable plaintiffs to establish both transaction and loss causation.

Causation in Securities Fraud Cases

Causation is a necessary element of securities fraud claims. In the securities context,

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causation is "two-pronged: a plaintiff must allege both transaction causation ... and loss causation."[3]

Transaction causation is "another way of

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describing reliance," and is established when the misrepresentations or omissions at issue cause the plaintiff to engage in the purchase or sale of the securities in question.[4]

Transaction causation may be established through the fraud on the market theory. Based largely on the U.S. Supreme Court's decision in *Basic v. Levinson*, that theory holds that, "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public misrepresentation, therefore, may be presumed for purposes of a Rule 10b-5 action."

Loss causation, on the other hand, generally refers to the requirement that plaintiffs demonstrate that their investments would not have lost value if the facts that defendants misrepresented or omitted had actually been true, and, thus, that the misrepresentation or omission caused the loss.[5]

Now codified in the PSLRA, 15 U.S.C. §78u-4(b)(4), loss causation is distinct from transaction causation as an element of proof in securities fraud claims. Thus, even in circumstances where "the investment decision is induced by misstatements or omissions that were material and relied upon by plaintiff" (in other words, where the existence of transaction causation is evident), if those misstatements or omissions "are not the proximate reason for his pecuniary loss, recovery ... is not permitted."[6]

Expanding Fraud on Market

Although the fraud on the market theory has traditionally been applied to transaction causation, there is, increasingly, some question concerning whether that theory can also be applied to loss causation.

Those seeking to apply the fraud on the market theory to loss causation utilize an approach sometimes called the "price inflation" or "price disparity" theory.

They contend that, because fraudulent information disseminated on an efficient market leads to an artificially inflated price of the stock at issue, loss causation exists because plaintiffs would not have purchased the stock if they had known it was falsely inflated or because they paid too much for it. There is, however, no consensus among courts on this issue.

A number of decisions suggest that the fraud on the market theory can be applied to establish loss causation. The most recent court to do so is the Ninth Circuit in *Broudo*.

That case was brought on behalf of investors in Dura Pharmaceuticals who claimed that the company issued material misstatements concerning the development of a new device for delivering asthma medication. When the company announced that it expected lower revenues than it had previously forecast, its stock suffered a single-day 47 percent drop. The announcement said nothing about the asthma device. However, after the close of the class period, the company disclosed that the FDA had denied its application for the asthma device.

In dismissing plaintiffs' claim, the district court focused on the fact that the disclosure that caused the sharp share price decline did not mention the asthma device, and reasoned that "any omission or misleading statements about this device could not be said to have caused the decline in price." As a result, it held that "the loss causation element was not met."

The Ninth Circuit reversed. It accepted, without comment, the premise that, "[i]n a fraud on the market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation."

It also noted, again without elaboration, that "for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the transaction."

Based on these principles, it held that pleading loss causation in securities fraud claims "merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause [of the overstatement]."

The Ninth Circuit therefore reversed the district court's dismissal because plaintiffs "ha[d] pled that the price of the stock was overvalued in part due to the misrepresentations." The Eighth Circuit adopted a similar approach 12 years earlier in *In re Control Data Corp. Securities Litig.*[7]

Other courts have rejected the double duty approach. The Eleventh Circuit did so in 1997 in *Robbins v. Koger Properties, Inc.*[8]

Most recently, Judge Milton Pollack did so in the *Merrill Lynch* case, a decision containing perhaps the most cogent analysis rejecting the application of the fraud on the market theory to satisfy both transaction and loss causation.

Plaintiffs had purchased Internet stocks during the height of the "internet bubble" and subsequently lost money. In an effort to recoup their money, they brought claims for securities fraud under Section 10(b), alleging that the financial projections and investment ratings contained in Merrill Lynch's analyst reports concerning those companies' stocks were materially inaccurate and caused their losses.

Employing a "fraud on the market theory," plaintiffs contended that they relied on the analyst reports even though none of them was alleged actually to have seen or read any of the reports.

Defendants also contended that any reduction in the price of the shares held by plaintiffs was caused by the bursting of the "Internet bubble" and the resultant general stock market drop (for which defendants were not responsible), not the contents of analyst reports.

Judge Pollack agreed, stating that he was "utterly unconvinced" that fraud had occurred. In so doing, he rejected plaintiffs' effort to rely upon the fraud on the market theory to satisfy the loss causation pleading requirement.

Specifically, he found that "[t]o permit plaintiffs to allege artificial inflation through the fraud on the market theory to satisfy loss causation would improperly conflate both the ... transaction causation and the loss causation elements into one." The effect of such a ruling would be to convert the securities laws into a "scheme of cost-free speculators' insurance" policy, indemnifying plaintiffs against all the downside risks of their investment—regardless of whether those risks were attributable to defendants.

> *While the courts may sort out this issue over time, there are several reasons why permitting loss causation to be satisfied through the fraud on the market theory is inappropriate.*

This the court would not do, explaining in no uncertain terms what it believed plaintiffs were up to:

> Seeking to lay the blame for the enormous Internet Bubble solely at the feet of a single actor, Merrill Lynch, plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches but which delivered such riches to only a scant handful of lucky winners. Those few lucky winners, who are not before the Court, now hold the monies that the unlucky plaintiffs have lost fair and square and they will never return those monies to plaintiffs. Had plaintiffs themselves won the game instead of losing, they would have owed not a single penny of their winnings to those they left to hold the bag (or to defendants).

Accordingly, plaintiffs' claims were dismissed.

While the courts may sort out this issue over time, there are several reasons why permitting loss causation to be satisfied through the fraud on the market theory is inappropriate.

First, this approach is not faithful to the U.S. Supreme Court's reasoning in adopting the fraud on the market theory in *Basic*. That decision makes plain that the fraud on the market theory can be used to create a rebuttable presumption of reliance (e.g., transaction causation), not loss causation.

Second, if the fraud on the market theory can serve double duty in this way, then the distinction between these two forms of causation will have collapsed. This is inappropriate. The PSLRA expressly codifies loss causation as a separate, free-standing element of a Section 10(b) claim. It should be treated as such.

Moreover, transaction causation and loss causation are conceptually different: transaction causation embodies an investor's reliance on fraudulent information in electing to engage in a purchase or sale, while loss causation reflects the fraudulent information's impact on the stock price. Using fraud on the market theory for both elements renders this distinction meaningless.

Third, conflating transaction causation and loss causation leads to a troubling and unworkable result. Loss causation ensures the existence of an identifiable causal nexus between a defendant's alleged misconduct and plaintiffs' claimed loss. It therefore enables courts to take account of intervening causes, such as recessions, wars or other external events which may be responsible for plaintiffs' losses, and for which a particular defendant should not be held liable.

As Judge Pollack explained in *Merrill Lynch*, without a requirement of proof of loss causation, the securities laws become a cost-free form of insurance against stock price drops, whether attributable to defendant or not. It is, therefore, critical to maintain loss causation as a separate element of a securities fraud claim.

(1) *Merrill Lynch & Co. Research Reports Securities Litig.*, --- F. Supp. 2d ---, 2003 WL 21500293 (S.D.N.Y. June 30, 2003), reconsideration denied, 2003 WL 21920386 (S.D.N.Y. Aug. 12, 2003).

(2) *Broudo v. Dura Pharmaceuticals, Inc.*, --- F.3d ---, 2003 WL 21789028 (9th Cir. Aug. 5, 2003).

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

(4) See *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988) (citing *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974)).

(5) See, e.g., *Suez Equity*, 250 F.3d at 96.

(6) *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375 (1983) (citing *Marbury Mgt., Inc. v. Kohn*, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting)).

(7) 933 F.2d 616 (8th Cir. 1991).

(8) 116 F.3d 1441 (11th Cir. 1997).