

# Loss Causation and Rule 10b-5 Damages After *Dura*



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**How Markets Work<sup>SM</sup>**

# *Dura Pharmaceuticals, Inc. v. Broudo:* The Decision, In a Nutshell



## Question Presented:

“Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment’s subsequent decline in price.”

## Decision Rendered:

Yes. “Normally, in cases such as this one (i.e., fraud-on-the market cases), an inflated purchase price will not itself constitute or proximately cause the relevant economic loss.”

# One Authority's Assessment



- “In its eagerly-awaited opinion in *Dura Pharmaceuticals, Inc. v. Broudo*, the United States Supreme Court attempts to clarify the critical concept of ‘loss causation’ in private securities fraud litigation. The Court’s decision, however, is actually **inconsistent** with the federal securities laws, **incoherent** in its reliance upon an amoebic notion of ‘economic loss,’ **incomplete** in its failure to address pressing causation questions, and ultimately **inconsequential**.” (emphasis added)

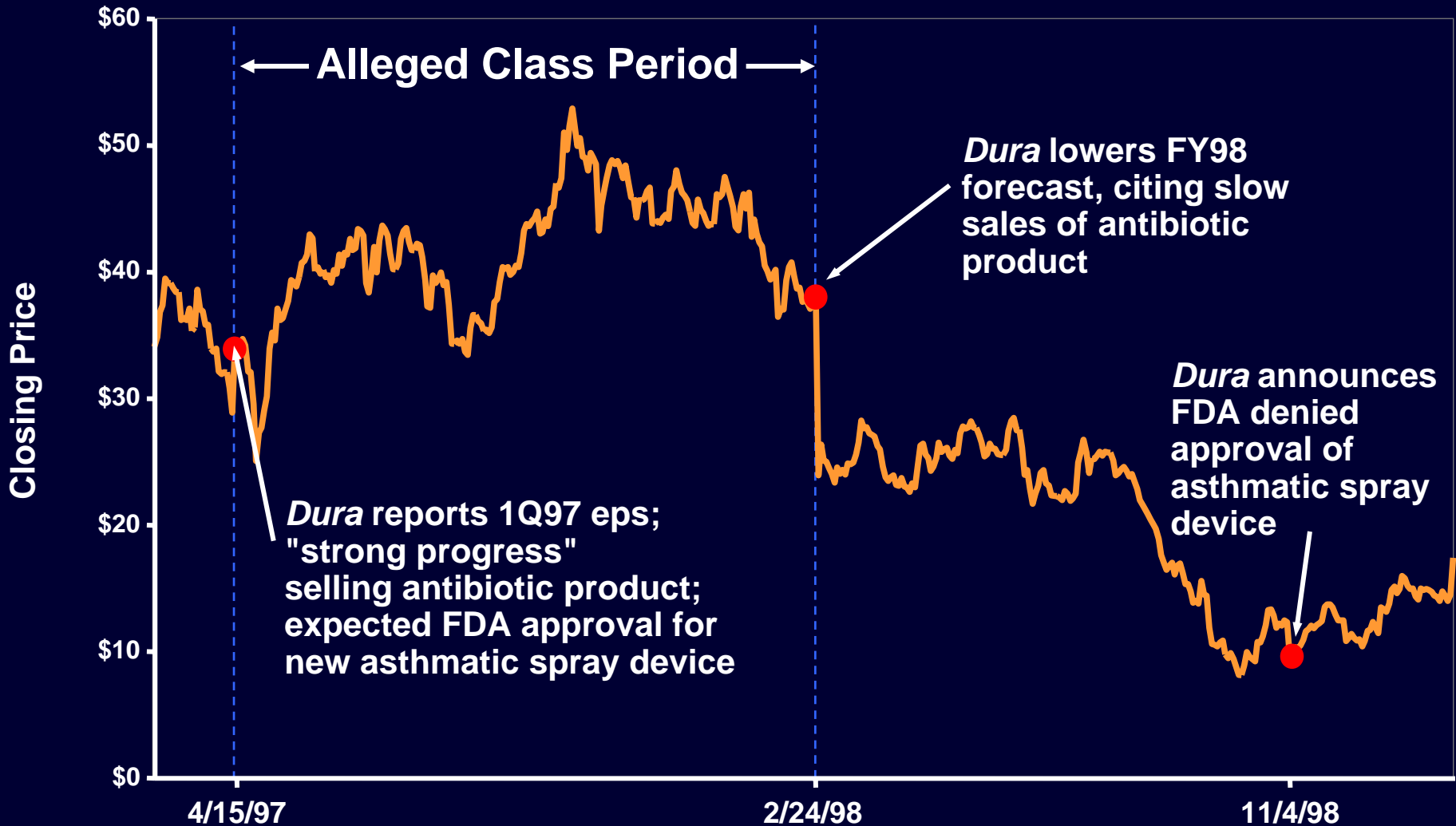
-Michael J. Kaufman, *Securities Litigation: Damages*, Vol. 26, 2005 at 11A-2.

# Loss Causation and Rule 10b-5 Liability Before *Dura* (April 19, 2005)



- Purchase inflation is sufficient
  - *Brouda v. Dura Pharmaceuticals* (9th Cir. 2003)
- Corrective disclosure followed by price drop is necessary
  - *Robbins v. Koger Properties* (11th Cir. 1997)
  - *Semerenko v. Cendant* (3rd Cir. 2000)
  - *Emergent Capital Inv. Mgmt v. Stonepath* (2nd Cir. 2003)

# Dura Pharmaceuticals



# The District Court's Ruling on Motion to Dismiss SAC



- Dismissed antibiotic allegation, finding that plaintiffs did not adequately allege *scienter*.
- Dismissed asthmatic spray device allegation, finding that plaintiffs **did not adequately allege loss causation**
  - Stock drop in February 1988 was unaccompanied by news concerning the device
  - “...the SAC does not explain how the alleged misrepresentation and omissions regarding [the asthmatic spray device] ‘touched’ upon the reasons for the decline in Dura’s stock price.”

# The Ninth Circuit's Ruling



- Reversed the District Court. Plaintiffs adequately alleged loss causation by alleging purchase at an inflated price
  - “...the injury occurs at the time of the transaction....Thus, loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause.”

# The US Supreme Court's Ruling



Reversed the 9<sup>th</sup> Circuit. Plaintiffs did not adequately allege loss causation. *Purchase inflation does not suffice.*

- “An inflated purchase price will not by itself constitute or proximately cause the relevant economic loss needed to allege and prove ‘loss causation.’”
- “...the moment the transaction takes place, the plaintiff has suffered no loss because the inflated purchase price is offset by ownership of a share that possesses equivalent value at that instant. And the logical link between the inflated purchase price and any later economic loss is not invariably strong, since other factors may affect the price.”

# What Does *Dura* Require for Loss Causation?



## *Revelation of the relevant truth must cause loss*

- “But if, say, the purchaser sells the shares quickly before **the relevant truth begins to leak out**, the misrepresentation will not have led to any loss.”
- “If the purchaser sells later after **the truth makes its way into the market place**, an initially inflated purchase price *might* mean a later loss.”
- “The complaint’s failure to claim that Dura’s share price fell significantly **after the truth became known** suggests that the plaintiffs considered the allegation of purchase price inflation alone sufficient. The complaint contains nothing that suggests otherwise.”
- “...the Ninth Circuit’s approach would allow recovery where a misrepresentation leads to an inflated purchase price, but does not **proximately cause** any economic loss.”

# What Must a Plaintiff Plead and Prove to Establish Loss Causation?



**Inflation is present on purchase**

**...and falls over the holding period**

**...due to revelation of the relevant truth**

**...by means of a disclosure that concedes the facts alleged to have been misrepresented or omitted**

**Plaintiffs & 9<sup>th</sup> Circuit**

**US Supreme Court**

**Defendants**

# Overpaying More on Purchase than One Recoups on Sale May Not Be Sufficient to Support a 10b-5 Claim

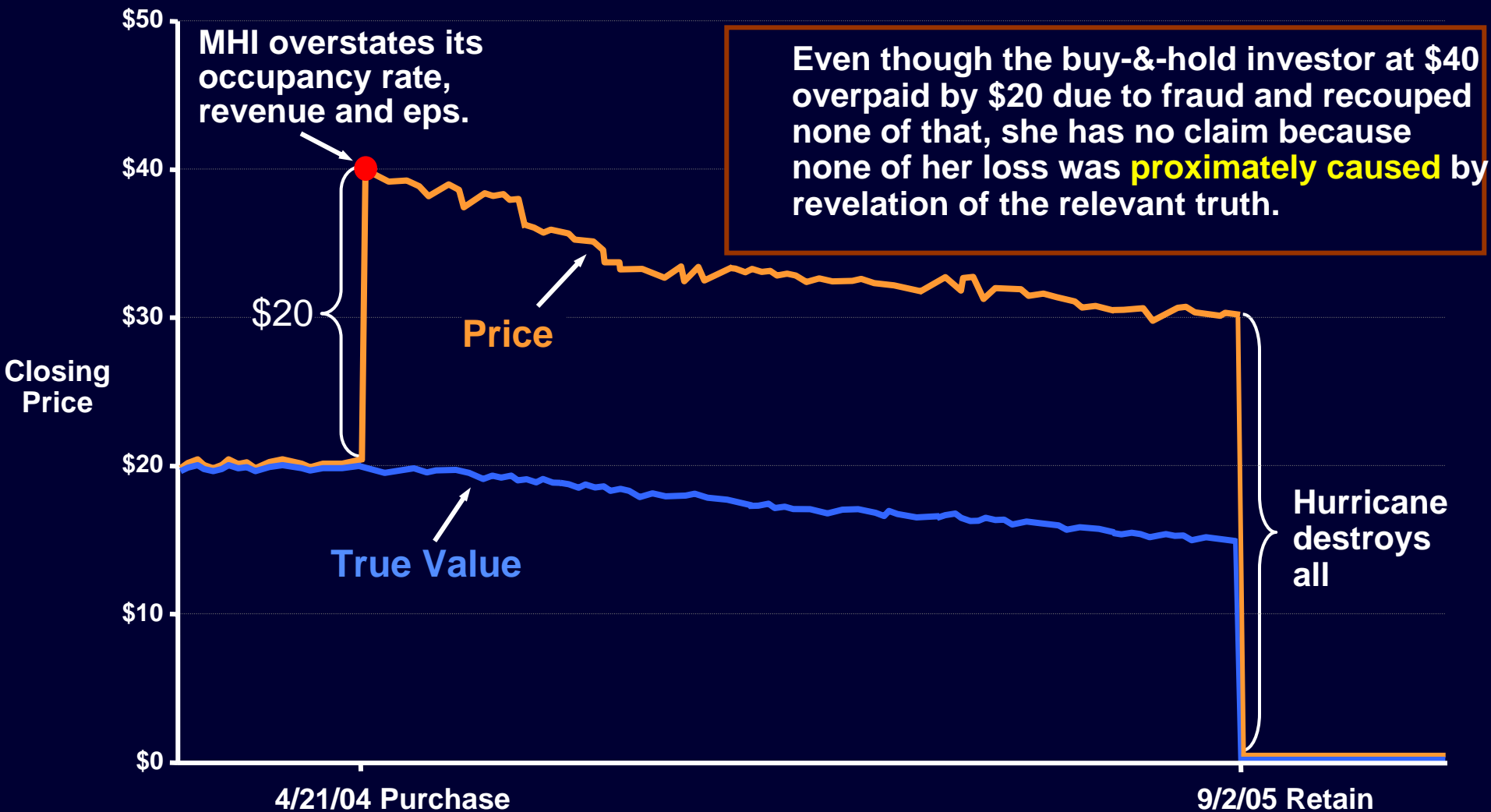


- If revelation of the relevant truth is not what caused the market's valuation of a fraudulent misrepresentation (i.e., inflation) to fall over the holding period, plaintiffs cannot establish loss causation.
- Other things that may cause inflation to fall:
  - Inflation from an overstatement of oil reserves falls as the price of oil comes down (*Green v. Occidental*)
  - Inflation from new drug hype falls when a competitor launches a superior product
  - Inflation from an earnings overstatement falls
    - when the market or industry slides, lowering P/E ratios
    - with the passage of time, as the information ages out
    - when natural or man-made disaster destroys the business

# Mobile Homes Inc. Hurricane Wipes Out Trailer Stock and Stock Price, Including Inflation



What is the Damage to a Retained Purchase? \$0.



# What Does It Take for a Disclosure to Be Relevant?



- Defendant-friendly answer:
  - **Explicit admission** that the misrepresentation was false when made, or that material facts were omitted.
  
- Plaintiff-friendly answer:
  - **Lowering of expectations** predicated on the misrepresentation or omission are unwarranted.

# Must the Misrepresentation Actually Be Corrected for a Disclosure to be Deemed Relevant?



- The Misrepresentation:
  - “3Q04 revenue was \$1 billion and EPS was \$0.24.”
- The Truth
  - Revenue was recognized prematurely. Undisclosed side agreements gave distributors unlimited rights of return.
- What counts as revelation of the relevant truth?
  - Defendant-friendly answer: Company must restate.
    - “3Q04 actually had revenue of \$700 million and EPS of \$0.01.”
  - Plaintiff-friendly answers: Revenue or EPS estimates fall.
    - Company reports, “4Q04 EPS was \$0.02 v. analyst estimates of \$0.25.”
    - Or: “For 1Q05, we’re now projecting EPS of \$0.14, down from \$0.26.”
    - Or: “We’re seeing unusually heavy returns from our channel partners.”
    - Or: “Our largest distributor has declared bankruptcy.”

# Whose Perspective Matters?



## Chronology:

- EPS Misrepresentation: “3Q04 EPS was \$0.24.”
- Rob purchases shares
- **Gold Misrepresentation: “Gold was discovered at our new mine.”**
- EPS Disclosure: “3Q04 EPS was \$0.01.
- Rob sells his shares
- **Gold Disclosure: “No gold deposits have been confirmed.”**

If inflation rose during his holding period, did Rob suffer a compensable loss? Two possible answers:

- No. Gold Inflation is irrelevant to Rob since he didn't overpay on account of it.
- Yes. Any inflation benefit that a plaintiff derives on sale reduces the net harm that was caused her by the fraud.



## Implications of *Dura* for Rule 10b-5 Damages

# *Dura* Offers No Explicit Guidance on Many Issues Pertaining to Damages



- The behavior of inflation
  - Words absent from the decision: constant, fixed, percent, variable
- The role of inflation
  - “An inflated purchase price will not **by itself** constitute or proximately cause the relevant economic loss needed to allege and prove ‘loss causation.’” (emphasis added)
  - So how **does** purchase inflation affect damages?
  - And, does sale inflation also matter?
- The role of netting (i.e., reduction of fraud-caused loss by fraud-caused gain)
  - Are fraud-caused gain and loss measured symmetrically? If so, what does that entail?
  - What kinds of sales give rise to gain that a damages analysis must recognize?
    - Short sales?
    - Sales of initial holdings (i.e., pre-fraud purchases)?
    - Or sales of class period purchases only?



- Measurement of Inflation
  - The “constant dollar” method is not the only one consistent with *Dura*. On the contrary: **no inflation measure is precluded**. Percentage and other variable inflation methods remain viable.
- Relevance of Inflation
  - *Dura* weakens the link between inflation drop over the holding period and damage per share. **The only post-purchase inflation drops that affect damages are those caused by revelation of the relevant truth.**

## Damage Per Share Under *Dura*

# *Dura* Has Clear Implications for Damage Per Buy-&-Hold Share and Per In-Out Share



Damage per share is the minimum of

## 1. inflation drop during the holding period

- This is the maximum possible loss sustainable **in connection with** a purchase. If purchase occurs before any material misrepresentation or omission, purchase inflation is 0, hence damage per share is 0.

## 2. Price drop during the holding period caused by revelation of the relevant truth

- If this itself were the measure of damage/share, pre-fraud purchasers could be claimants. Because case law requires 10b-5 liability to be in connection with a purchase or sale, this measure alone is insufficient.
- If sale precedes any revelation of truth, damage/share is 0.



# Example 1: Damage Per Share When Inflation Is Constant Until Revelation of the Truth

**Sole Corrective  
Disclosure Is  
Post-Close on  
Day 2**

	Day 1	Day 2	Day 3
Price	30	30	24
True Value	24	24	24
Inflation	6	6	0
Loss Caused By Revelation of Truth			6

**Price Drop =  
Inflation Drop  
= Damage/Shr**

	Day 1 Sale	Day 2 Sale	Hold
Day 1 Buy	0	0	6
Day 2 Buy		0	6



# Example 2: Damage Per Share When Inflation Declines Before Revelation of the Truth: What It's *NOT*

	Day 1	Day 2	Day 3
Price	100	30	24
True Value	80	24	24
Inflation	20	6	0
Loss Caused By Revelation of Truth			<b>6</b>

**Inflation Drop over Holding Period**

	Day 1 Sale	Day 2 Sale	Hold
Day 1 Buy	0	14	20
Day 2 Buy		0	6

# Example 2: Damage Per Share When Inflation Declines Before Revelation of the Truth: What It IS



	Day 1	Day 2	Day 3
Price	100	30	24
True Value	80	24	24
Inflation	20	6	0
Loss Caused By Revelation of Truth			<b>6</b>

	Day 1 Sale	Day 2 Sale	Hold
Day 1 Buy	0	0	6
Day 2 Buy		0	6

**Damage per Share**



# Example 3: Damage Per Share When Inflation Rises Before Revelation of the Truth: What It's *NOT*

	Day 1	Day 2	Day 3
Price	30	80	64
True Value	24	64	64
Inflation	6	16	0
Loss Caused By Revelation of Truth		<b>16</b>	

## Inflation Drop on Revelation of the Truth

	Day 1 Sale	Day 2 Sale	Hold
Day 1 Buy	0	0	16
Day 2 Buy		0	16

# Example 3: Damage Per Share When Inflation Rises Before Revelation of the Truth: What It IS



	Day 1	Day 2	Day 3
Price	30	80	64
True Value	24	64	64
Inflation	6	16	0
Loss Caused By Revelation of Truth			<b>16</b>

	Day 1 Sale	Day 2 Sale	Hold
Day 1 Buy	0	0	6*
Day 2 Buy		0	16

**Damage per Share**

\*0 after bounce-back cap

# Example 4: Damage Per Share Given More than One Curative Disclosure



	Day 1	Day 2	Day 3	Day 4	Day 5
Price	100	80	60	30	24
True Value	60	48	48	24	24
Inflation	40	32	12	6	0
Loss Caused By Revelation of Truth			20		6

	Day 1 Sale	Day 2 Sale	Day 3 Sale	Day 4 Sale	HOLD
Day 1 Buy	0	0	20	20	26
Day 3 Buy			0	0	6

**Damage per Share**

# Example 5: Damage Per Share When Each Curative Disclosure Is Coupled With Timely Bad News



	Day 1	Day 2	Day 3	Day 4	Day 5
Price	100	80	60	30	24
True Value	80	64	54	27	24
Inflation	20	16	6	3	0
Loss Caused By Revelation of Truth			<b>10</b>		<b>3</b>

	Day 1 Sale	Day 2 Sale	Day 3 Sale	Day 4 Sale	HOLD
Day 1 Buy	0	0	10	10	13
Day 3 Buy			0	0	3

**Damage per Share**



## Damage Per Claimant Under *Dura*: Alternative Possibilities

# Example 6: Damage Per Claimant With Multiple Purchases and No Sales Is Straightforward



	Disclosure 1		Disclosure 2			Components of 10b-5 Loss
	Day 1	Day 2	Day 3	Day 4	Day 5	
Price	\$100	\$80	\$66	\$44	\$30	
Inflation	\$20	\$16	\$6	\$4	\$0	
Loss Caused By Revelation of Truth		<b>\$10</b>		<b>\$4</b>		
Purchase	500					$\$7,000 = 500 * \$14$
Purchase				300		$\$1,200 = 300 * \$4$
Total						<b>\$8,200</b>

# Example 7:

But Damage Per Claimant with Unequal Purchases and Sales Is *Not* So Clear-Cut



## Components of 10b-5 Loss (Gain)

	Disclosure 1		Disclosure 2			Components of 10b-5 Loss (Gain)	
	Day 1	Day 2	Day 3	Day 4	Day 5	Gains Unconstrained	Gains and Losses Treated Symmetrically
Price	\$100	\$80	\$66	\$44	\$30		
Inflation	\$20	\$16	\$6	\$4	\$0		
Loss Caused By Revelation of Truth		<b>\$10</b>		<b>\$4</b>			
Purchase	500					$\$7,000 = 500 * \$14$	$\$7,000 = 500 * \$14$
Sell			(300)			$(\$1,800) = (300) * \$6$	$\$1,200 = (300) * \$4$
Total						<b>\$5,200</b>	<b>\$5,800</b>

# What Would Symmetrical Treatment of Gains and Losses Entail, Given *Dura's* Approach to Measuring Loss?



- **Purchase - Sale Symmetry** (does not require paired transactions)

Loss on purchase = the minimum of (1) purchase inflation & (2) post-purchase price drop caused by revelations of relevant truth

therefore

Gain on sale = the minimum of (1) sale inflation & (2) post-sale price drop caused by revelations of relevant truth

Rationale: Selling averts Loss from holding through truth revelations

- **In - Out Symmetry** (does required paired transactions)

Loss on in-outs sold before revelation of relevant truth = 0, even if inflation **falls** over the holding period

therefore

Gain on in-outs sold before a new misrepresentation = 0, even if inflation **rises** over the holding period

Rationale: Fraud was not the proximate cause of the Gain.

Example 8:  
 Damage Per Claimant with Unequal Purchases and Sales  
 May Be Straightforward If Gains and Losses Are Treated  
 Symmetrically, Regardless How Symmetry Is Defined



	Disclosure 1		Disclosure 2		Components of 10b-5 Loss (Gain)	
	Day 1	Day 2	Day 3	Day 4	Purchase-Sale Symmetry	In-Out Symmetry
Price	\$100	\$80	\$66	\$44		
Inflation	\$20	\$16	\$6	\$4		
Loss Caused By Revelation of Truth		<b>\$10</b>		<b>\$4</b>		
Purchase	500				$\$7,000 = 500 * \$14$	$\$2,800 = 200 * \$14$
Sell			(300)		$(\$1,200) = (300) * \$4$	$\$3,000 = 300 * \$10$
Total					<b>\$5,800</b>	<b>\$5,800</b>

# Example 9: However, Different Notions of Symmetry *May* Yield Measures of Damage Per Claimant



	Disclosure 1		Disclosure 2		Components of 10b-5 Loss (Gain)	
	Day 1	Day 2	Day 3	Day 4	Purchase-Sale Symmetry	In-Out Symmetry
Price	\$40	\$85	\$66	\$44		
Inflation	\$8	\$17	\$6	\$4		
Loss Caused By Revelation of Truth		<b>\$11</b>		<b>\$4</b>		
Purchase	200				$\$1,600 = 200 * \$8$	$\$0 = 200 * \$0$
Sell		(200)			$(\$3,000) = (200) * \$15$	
Sell				500	$\$2,000 = 500 * \$4$	$\$2,000 = 500 * \$4$
Total					<b>\$600</b>	<b>\$2,000</b>

# First Proposed Solution: Purchase - Sale Symmetry, In - Out Asymmetry



- *Dura* offers no guidance on **damage per claimant**. I previously proposed:
  - Recognize a fraud-caused loss (“**Loss**”) on every purchase by treating it as a buy-&-hold.  $\text{Loss} = \min(\text{purchase inflation}, \text{Loss Causation Cap})$ .
    - Loss Causation Cap = sum of all subsequent abnormal price drops upon revelation of relevant truth.
  - Recognize a fraud-caused gain (“**Gain**”) on every sale by treating it as a Loss avoided.  $\text{Gain} = \min(\text{sale inflation}, \text{Loss Causation Cap})$ .
  - Damages = Total Losses - Total Gains (if  $>0$ , and 0 otherwise).
- This treats Gain and Loss symmetrically in one respect but not in another:
  - **Purchase-Sale Symmetry** :  
Gain per share sold = Loss per same-day buy-&-hold share purchased
  - **In-Out Asymmetry**: In-outs sold before a revelation of truth may cause a Gain (equal to rise in inflation) even though they may not cause a Loss

**Both types of symmetry are desirable for purposes of passing the “blush test,” but they sometimes are mutually incompatible.**

# Latest Thinking: No Symmetry Required



- Use FIFO or other fixed linking rule to pair off an investor's buys and sells to the fullest extent possible.
- Measure **Loss (Gain)** on each paired trade as follows:
  - If inflation fell over the holding period,
    - Loss = min (drop in inflation, drop in Loss Causation cap)
  - If inflation rose over the holding period,
    - Gain = rise in inflation
- Recognize a **Loss (Gain)** on every unpaired trade
  - On a stand-alone purchase (retained purchase)
    - Loss = min (purchase inflation, Loss Causation cap)
  - On a stand-alone sale (sale of initial holdings or short sale)
    - Gain = sale inflation
- Damages = Total Losses - Total Gains (if >0, 0 otherwise).

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