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Proffering the Right Evidence: Proving Loss Causation and Damages Under SEC Rule 10b-5

I. INTRODUCTION*

The Securities and Exchange Commission’s primary weapon against securities fraud is Rule 10b-5’s implied cause of action,1 which forbids fraudulent acts “in connection with the purchase or sale of any security.”2 In order to bring a claim for monetary relief under Rule 10b-5, a plaintiff must establish economic loss.3 In practice, however, it appears that litigants seeking to establish the elements of a private claim under Rule 10b-5 leave the question of damages to be resolved on another day, as the overwhelming majority of these actions are either settled or dismissed prior to trial.4 For clarity, just twenty-two securities fraud class action cases have been tried to a verdict since the enactment of the Private Securities Litigation Reform Act of 1995 (PSLRA).5 Given the dearth of these cases proceeding to trial, the few courts confronted with the issue of damages have espoused a “bewildering mix of standards, often using the same terms, but frequently giving them radically different interpretations and doing little to resolve the inconsistencies.”6 Indeed, one court observed that “[a]nyone exploring the issue of Rule 10b-5 damages would be immediately confronted with the repeated observation that this is a confused area of the law where the courts, forced to rely on their own

* In substance, this Note is limited to § 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. Also, this Note uses the terms “§ 10(b)” and “Rule 10b-5” interchangeably unless otherwise specified.

2. 17 C.F.R. § 240.10b–5.
6. Lowenfels & Bromberg, supra note 4, at 1107.
wits, have crafted a myriad of approaches."

Two recent federal district court decisions provide a degree of clarity to the § 10(b) and Rule 10b-5 damage calculus. Liberty Media v. Vivendi Universal8 and Lawrence Jaffe Pension Plan v. Household International9 illuminate how plaintiffs' counsel successfully defended jury awards under Rule 10b-5 against post-trial attacks on their damages presentations to the jury.10 These rulings provide important guidance as to what is precisely required of securities fraud plaintiffs to prove loss causation and damages at trial.11 Part II of this Note begins by examining § 28(a) of the 1934 Act,12 which has been interpreted to limit recovery under § 10(b) and Rule 10b-5 to "actual damages."13 Part II then assesses the PSLRA's formulaic loss calculation model and surfaces problems inherent in its design and application, ultimately suggesting that despite its facial simplicity, the PSLRA requires the removal of non-fraud, price-influencing factors from loss calculation under Rule 10b-5.14 Part II concludes with an illustration highlighting one of the many unpredictable approaches employed by courts in removing these extraneous market factors from the price of a security.15 Subsequently, in Part III, this Note studies three important components of the Liberty Media and Household opinions: (i) the disaggregation of non-fraud-related factors from the price of a security, (ii) the leakage theory of proving loss causation and damages, and (iii) the maintenance theory of inflation.16 This Note closes by observing that the approaches endorsed by the U.S. district courts in Liberty Media and Household for proving loss causation and damages strike the right balance with the mandates of § 28(a) of the 1934 Act and the PSLRA, limiting the remedy under § 10(b) and Rule 10b-5 to "actual damages" caused by the defendant's fraudulent conduct.

7. See Koch v. Koch, 6 F. Supp. 2d 1192, 1201 (D. Kan. 1998) (citing DCD Programs v. Leighton, 90 F.3d 1442, 1446 (9th Cir. 1996)).
10. Matthew L. Mustokoff & Margaret E. Onasch, Rule 10b-5 Damages at Trial Stage, A.B.A. (July 16, 2013), [hereinafter Damages at Trial].
11. Id.
13. See infra Part II.A.
14. See infra Part II.C.
15. See infra Part II.D.
16. See infra Part III.B, III.C, III.D, respectively.
II. BACKGROUND

A. Section 28(a) of the Securities Exchange Act of 1934

The private right of action under § 10(b) of the 1934 Act is a product of judicial implication.\(^\text{17}\) The federal courts first implied this private cause of action in 1946 during an era where every wrong was deemed to have a remedy.\(^\text{18}\) It therefore comes as no surprise that courts have struggled to find statutory guidance for a precise loss calculation formula under Rule 10b-5.

Section 28(a) of the 1934 Act limits recovery of claims brought under the 1934 Act to "actual damages."\(^\text{19}\) Since Rule 10b-5 actions are implied causes of action and not technically codified under the 1934 Act, at least one court has held that claims under Rule 10b-5 are not within § 28(a)'s purview.\(^\text{20}\) The Supreme Court, however, in *Affiliated Ute Citizens of Utah v. United States*\(^\text{21}\) interpreted § 28(a) as governing the measurement of damages permissible under § 10(b).\(^\text{22}\) *Affiliated*, which involved violations of § 10(b) and Rule 10b-5 by a purchaser of securities, held that ordinarily the correct measure of damages under § 28(a) 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 . . . except for the situation where the defendant received more than the [plaintiff's] actual loss."\(^\text{23}\) According to the Court, in the second scenario, recovery is limited to the defendant's profit.\(^\text{24}\) Therefore, *Affiliated* plainly suggests that "actual

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18. Id.
24. Id.
"damages" are not limited to a plaintiff's out-of-pocket loss, but may also include any windfall gained by the fraudulent party.\(^{25}\)

Subsequently, in *Randall v. Loftsgaarden*,\(^ {26}\) plaintiffs brought suit under § 12(2)\(^ {27}\) of the Securities Act of 1933\(^ {28}\) and § 10(b) for the fraudulent promotion of tax shelters, which were purchased by plaintiffs.\(^ {29}\) The Supreme Court held that rescissory damages also fall within § 28(a)'s mandate and that such award need not be reduced by any net tax benefit to plaintiffs.\(^ {30}\) However, because the Court has not elicited any further discussion pertaining to damages under § 10(b), the lower federal courts have "digress[ed] into alternative measures of damages that sometimes consist of combining the out-of-pocket measure with an additional measure or measures as in *Affiliated Ute* or using a basically different measure as in *Randall*."\(^ {31}\)

**B. Traditional Loss Calculation Models**

The dominant view among the lower courts is that an out-of-pocket recovery measure is the appropriate measure of damages under a Rule 10b-5 action.\(^ {32}\) The rationale behind the out-of-pocket damages theory "is to award not what the plaintiff might have gained, but what he lost by being deceived into the purchase."\(^ {33}\) It is well settled, however, that a trial judge may employ an alternative measure should the facts so warrant.\(^ {34}\) Under certain fact patterns, courts have

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\(^{25}\) See *Randall*, 478 U.S. at 663.

\(^{26}\) 478 U.S. 647 (1986).

\(^{27}\) This provision was subsequently amended and is now codified as § 12(a)(2) of the Securities Act. See 15 U.S.C.A. § 77a (1933).


\(^{29}\) *Randall*, 478 U.S. at 663.

\(^{30}\) Id.

\(^{31}\) Lowenfels & Bromberg, *supra* note 4, at 1092-93.

\(^{32}\) *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972) (stating that recovery "is the difference between the fair value of [what plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct . . ."). For cases applying this measure, see *Pelletier v. Stuart-James*, 863 F.2d 1433, 1437 n. 2 (9th Cir. 1989); *Woods v. Barrett Bank of Ft. Lauderdale*, 765 F.2d 1004 (11th Cir.1985); *Alna Capital v. Wagner*, 758 F.2d 562 (11th Cir.1985); *Hackbart v. Holmes*, 675 F.2d 1114 (10th Cir.1983).

\(^{33}\) *DCD Programs v. Leighton*, 90 F.3d 1442, 1447 (9th Cir. 1996) (citing *Wool v. Tandem Computers*, 818 F.2d 1433, 1437 n. 2 (9th Cir.1987)).

\(^{34}\) *Randall*, 478 U.S. at 662 (citing *Blackie v. Barrack*, 524 F.2d 891, 909 (9th Cir. 1975)).
calculated damages based on different formulas, such as the benefit of the bargain or rescissory damages. The former may be appropriate in cases involving a breach of promise, state law breach of contract claim, or a claim based on breach of common law fiduciary duty. When plaintiff's claim is based on fraud in the inducement (i.e., plaintiff would not have entered into the deal but for the defendant’s fraud”), rescission may be appropriate. Furthermore, some courts have required the disgorgement of profits in cases involving unjust enrichment or restitution. It is rare, though, to see this remedy employed in cases not involving insider trading.

Rudimentarily, under the out-of-pocket theory, a defrauded purchaser is entitled to recover the difference between the price paid for the security and the actual value of that security on the date of the initial purchase or sale. Determining out-of-pocket loss can be a daunting task for a trial court. The difficulty, of course, is determining the actual value of the security at the time of the purchase or sale. Due to the difficulties surrounding this calculation, Congress, through the PSLRA, amended the 1934 Act by passing § 21D(e), which, on its

38. See id. at 191 (citing Panos v. Island Gem Enterprises, 880 F. Supp. 169 (S.D.N.Y. 1995)).
39. See id. (citing Ambassador Hotel v. Wei-Chuan Investment, 189 F.3d 1017 (9th Cir. 1999)).
40. Id. at 192 (rev. 6th ed. Supp. 2009).
41. See Litton Indus. v. Lehman Bros. Kuhn Loeb, 734 F. Supp. 1071, 1076 (S.D.N.Y. 1990) (stating that the proper measure of disgorgement damages would be difference between each defendant’s actual profit and amount disgorged to SEC); see also id. at 193.
42. See, e.g., SEC v. MacDonald, 699 F.2d 47, 48 (1st Cir. 1983) (requiring insider-defendant to disgorge profits representing the increased value of the shares at a reasonable time after public dissemination of the information); see also HAZEN HORNBOOK, supra note 3, at 193 (rev. 6th ed. Supp. 2009).
43. DCD Programs v. Leighton, 90 F.3d 1442, 1446 (9th Cir. 1996); DeBartolo Corp. v. Cooper’s & Lybrand, 928 F. Supp. 557, 565 (W.D. Pa. 1996); Kronfeld v. Advest, 675 F. Supp. 1449, 1455 (S.D.N.Y. 1987) ("Out-of-pocket loss is the difference between the price paid and the value received.").
face, may be interpreted as not requiring a determination of the "actual value" of the security at the time of purchase or sale.

**C. Private Securities Litigation Reform Act of 1995**

Private class actions brought under § 10(b) must abide by the exacting requirements set forth in the PSLRA. Although designed to cap damages to those caused by the defendant’s fraudulent conduct, the PSLRA provides a loss equation predicated solely on the security’s "mean trading price." Damages are calculated based on the "difference between the purchase or sale price paid or received . . . and the mean trading price of that security during the [ninety]-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." If the security is repurchased or sold by plaintiff within the ninety-day window, damages are to be calculated as the difference between the repurchase or sale price and "the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which plaintiff sells or repurchases the security." These damage limitation subsections of the PSLRA have been further interpreted to require an individual damages determination for each claimant, barring aggregation of losses incurred by all damaged shares. In other words, the PSLRA requires courts to examine evidence of each plaintiff’s proof of purchase and sale of the subject security in order to measure compliance with the Act.

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49. Id.


The value of the PSLRA derives from its ability to objectively calculate damages. The PSLRA’s component parts are “based upon objective trading data, easily obtained, which minimizes the speculation found in other proffered calculations.” Its advantages, however, do not come without considerable costs. One problem can occur when the price of a security has increased or decreased during the ninety-day window “for reasons wholly independent” of the underlying fraud. Any change in the security’s price which is attributable to non-fraud-related factors should be excluded from the calculation of loss because any corresponding effect on the security price was not caused by the fraud, but rather by “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events.” And in light of PSLRA’s lengthy lookback period, the greater the chances that other, non-fraud factors caused the loss. But, by looking only to the mean trading price of the subject security, the PSLRA appears not to require the removal of these extraneous market factors.

More fundamentally, the PSLRA’s ninety-day look-back provision is “inconsistent with the Efficient Market Hypothesis (EMH), upon which the entire theory of market loss is based.” The legislative history of the PSLRA explains that by “[c]alculating damages based on the date corrective information is disclosed may end up substantially overestimating plaintiff’s damages.” This reasoning does not comport with the EMH, which presumes that security prices respond quickly and accurately to the release of new information, often within seconds. Any “over-reaction” in the security’s price produces a simultaneous arbitrage opportunity for investors. Thus, a loss

57. Id.
58. Duncan, supra note 55, at 266 (citing Kevin P. McCormick, Untangling the Capricious Effects of Market Loss in Securities Fraud Sentencing, 82 TUL. L. REV. 1145, 1166 (2008)).
60. Duncan, supra note 55, at 265 (quotations omitted) (citations omitted).
61. Grundfest, supra note 17, at 42.
calculation that includes extraneous positive market forces that increase
the stock price during the ninety-day period will overestimate plaintiff’s
recovery. Conversely, a loss calculation that takes into consideration
extraneous negative market forces that depress the stock price during
the ninety-day window will improperly underestimate plaintiff’s
recovery.

The federal securities laws are not created “to provide investors
with broad insurance against market losses, but to protect them against
those economic losses” that are the result of the defendant’s fraudulent
conduct. Failing to exclude extraneous market factors from the
PSLRA’s loss calculation conflicts with § 28(a)’s mandate that loss be
limited to “actual damages,” as well as with the PSLRA’s loss causation
requirement. As to the former, because of the countless factors that
may affect a security’s price, the value of the security during the ninety-
day period after corrective information has been publicly disseminated
will sometimes result in a figure representing the actual value of the
security—but it is “far from inevitably so.” With respect to the latter,
any market activity that affects the price of the underlying security
should be removed from the security’s price because the loss that
occurred was not caused by the defendant’s conduct. Therefore, the
only sensible approach to damage calculation is to remove from the loss
calculation any non-fraud-related factors that have an effect on the price
of the underlying security during the materialization window, which,
under the PSLRA, is the ninety-day period following the revelation of
the fraud.

63. Id. at 266.
64. In re Omnicom Sec. Litig., 597 F.3d 501, 510 (2d Cir. 2010) (quoting Dura Pharm.
65. 15 U.S.C. § 78u-4(b)(4) (“In any private action arising under this chapter, 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.”).
67. The materialization window is the time span of the fraud. It begins when the fraud
is placed on the market and ends with its disclosure to the public (either through a corrective
disclosure or through materialization of the concealed risk as discussed supra). Dean
Furbush & Jeffrey W. Smith, Estimating the Number of Damaged Shares in Securities
Fraud Litigation: An Introduction to Stock Trading Models, 49 BUS. LAW. 527, 529 (1994)
(discussing the "time of the fraud"); see also Liberty Media v. Vivendi Univ., 923 F. Supp.
2d 511, 518 (S.D.N.Y. 2013) (acknowledging the nine days of materialization events).
The disaggregation of non-fraud, price-influencing factors from the loss calculation not only limits damages under Rule 10b-5 to those proximately caused by the defendant’s misstatement, omission, or conduct, but also produces a figure that more accurately represents plaintiff’s actual damages. At the pleading stage, however, courts do not always demand that plaintiffs “disaggregate their alleged losses.” It is generally sufficient to allege only “some indication of the loss and the causal connection” in order to create a question of fact. Likewise, plaintiffs are not invariably forced to show that all of their asserted losses resulted from the misstatement, omission, or misconduct of the defendant. According to a few courts, “plaintiff [need only] show that the defendant was responsible for a portion of those losses.” Nevertheless, during all stages of litigation, courts continue to encounter problems in this context because of the inherent difficulty of identifying and discounting non-fraud-related factors.

D. Determining Actual Value—Expert Testimony

In order to disaggregate extraneous market factors from the loss calculation model, plaintiffs must separate market risk (i.e., risk inherent to the market as a whole) from company risk (i.e., the risk specific to the security and its issuer). Commonly, the burden of

68. See Miller v. Asensio & Co., 364 F.3d 223, 227 (4th Cir. 2004) (stating that the defendant’s conduct must have proximately caused plaintiff’s injury).
71. Cadwalader, supra note 69, at 7.
72. Id. at 1-2 (emphasis in original). See, e.g., Abu Dhabi Commercial Bank v. Morgan Stanley, 888 F. Supp. 2d 431, 472 (S.D.N.Y. 2012) (holding that “[s]ummary judgment is inappropriate so long as plaintiffs provide evidence ‘that would allow a factfinder to ascribe some rough proportion of the whole loss to the defendant’s alleged misstatements.”) (quoting King County v. IKB Deutsche Industriebank AG, 708 F. Supp. 2d 334, 339 (S.D.N.Y. 2010) (emphasis in original)).
74. In re Executive Telecard Sec. Litig., 979 F. Supp. 1021, 1025 (S.D.N.Y. 1997) (citing BREALEY & MEYERS, PRINCIPLES OF CORPORATE FINANCE 173 (5th ed.1996)); see also Dura Pharm. v. Broudo, 544 U.S. 336, 342 (2005), (acknowledging that the “link between the inflated purchase price and any later economic loss is not invariably strong, since other factors may affect the price.”).
separating market and company risks from the price of a security involves the testimony of battling financial experts who estimate the price at which the subject security would have traded but for the alleged fraud. The expert's credibility and methodology are often vital to the success of any disaggregation presentation. Given the discretion afforded to trial judges, many courts have held that experts who purport to disintegrate market and company risks from the alleged fraud fail to establish a "reliable basis in the knowledge and experience of his discipline." In many cases, this is a result of the expert's failure to introduce "an event study or similar analysis" which is essential to effectively "isolate the influences of information specific" to the actions of the issuer which are alleged to be fraudulent.

An early illustration of the disaggregation of non-fraud-related factors from the value of a security is found in the 1975 opinion from the Southern District of New York, Beecher v. Able. In that case, experts from both sides sought to establish the "sharply contested" value of the subject security on the date of filing. The securities fraud allegations in Beecher related to a misleading prospectus and were brought under § 11 of the 1933 Act. While the measure of damages in

75. See, e.g., In re Oracle Sec. Litig., 829 F. Supp. 1176, 1181 (N.D. Cal. 1993); In re Executive Telecard Sec. Litig., 979 F. Supp. 1021, 1026; see also HAZEN HORNBOOK, supra note 3, at 185 (rev. 6th ed. Supp. 2009).

76. In Daubert, the Court espoused four factors for determining whether expert testimony is admissible. When a party proposes the introduction of an expert witness, a trial judge is required to decide (1) whether the expert's proffered "theory or technique . . . can be (and has been) tested," (2) "whether the theory or technique has been subjected to peer review and publication," (3) "the known or potential rate of error" of the expert's theory or technique, and (4) whether the theory or technique has been "generally accepted." Daubert v. Merrell Dow Pharmaceuticals, 509 U.S. 579, 580 (1993); see also HAZEN HORNBOOK, supra note 3, at 186 (rev. 6th ed. Supp. 2009).

77. See, e.g., In re Executive Telecard Sec. Litig., 979 F. Supp. at 1026 (quoting Daubert, 509 U.S. at 592); In re Oracle Sec. Litig., 829 F. Supp. at 1181; Kaufman v. Motorola, No. 95-C-1069, 2000 WL 1506892, at *2 (N.D. Ill. Sept. 21, 2000).

78. In re Executive Telecard Sec. Litig., 979 F. Supp. at 1026 ("Use of an event study or similar analysis is necessary more accurately to isolate the influences of information specific to Oracle which defendants allegedly have distorted. As a result of his failure to employ such a study, the results reached by [the expert] cannot be evaluated by standard measures of statistical significance. Hence, the reliability of the magnitude and direction of his value estimates are incapable of verification.") (citing In re Oracle Sec. Litig., 829 F. Supp. at 1181).


81. The court confined the potential damages "to those damages caused by the misleading break-even prediction in violation of § 11 of the Securities Act of 1933." Id.
an action under § 11 is expressly provided by statute, the Beecher court’s approach to valuing securities at the time of suit is analogous to determining the actual value of a security at the time of purchase or sale for the purposes of § 10(b) and Rule 10b-5.83

At the outset, the Beecher court recognized that the true value of a security could be “something other than [its] market price.” Using the market price as a starting point, the court determined that there was compelling evidence that “panic selling” altered the market price of the security on the day suit commenced. That is, according to the court, the actual value at the time of suit was somewhere below the security’s trading price. The court therefore modified the market price on the date of suit by adding $9.50 to the market price to arrive at a figure that represented a “fair value” of the securities (i.e., a value unmoved by the panic selling and other price-depressing factors on the date of suit). The court adhered to this calculation despite the liquid, sophisticated market on which the subject security was trading. The court took the position that it is not error to conclude both that the market for a given security is “sophisticated,” and that the same “market was occasionally irrational” and sets a price lower than the fair value of the security. Consequently, the court offset investors’ panic selling by adding to the security’s market price an amount that it felt represented a “probable recovery” by the defendant.

While it is widely accepted that many variables may be present in the materialization window which are both non-fraud-related and

82. In an action under § 11 of the Securities Act, the amount of damages is capped at “the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) . . . .” 15 U.S.C. § 77k (1933). In Beecher, plaintiffs sought to show the difference between the amount paid for the subject securities and the value at the time of suit.

83. See Beecher, 435 F. Supp. at 402.
84. Id. at 404.
85. Id. at 406.
86. Id.
87. Id.
88. Id. at 402.
89. Beecher, 435 F. Supp. at 405-06.
90. Id. at 406.
have an effect on the price of a security, courts continue to disagree as to how such extrinsic factors should be removed from the actual value calculation when determining out-of-pocket damages. The Beecher court looked to the market price of the security at the time of suit and adjusted that price upward for deflation that it found to be caused by panic selling. In Beecher, the justification for the price adjustment is questionable since the security was trading in a “sophisticated” market involving “a heavy volume of trading on national and over-the-counter exchanges.” But, nevertheless, Beecher demonstrates one of the many ad hoc and unpredictable approaches used by courts to calculate the actual value of a security by removing factors unrelated to the defendant’s conduct.

In addition to showing economic loss under Rule 10b-5, a plaintiff must also plead and prove loss causation. The close relationship between damages and loss causation often compels plaintiffs to place a dollar amount on a particular misrepresentation or omission during the pleading stage. As a natural result, the loss causation requirement ties into the damage calculus by often forcing a plaintiff to monetize losses at the outset of litigation.

E. Proving Loss Causation: Corrective Disclosure and Materialization of the Risk

Loss causation is the “casual nexus” between the defendant’s alleged misconduct and the monetary loss to plaintiff. Loss causation cannot be established “merely upon averments” that the defendant’s conduct affected the price of the subject security; rather, a plaintiff is

93. Id. at 402.
94. First Nationwide Bank v. Gelt Funding, 27 F.3d 763, 769 (2d Cir. 1994).
95. See HAZEN HORNBOOK, supra note 3, at 168 (rev. 6th ed. Supp. 2009); see also Oscar Private Equity Investments v. Allegiance Telecom, 487 F.3d 261 (5th Cir. 2007) (applying a narrow interpretation to the loss causation element).
required to allege that the financial harm endured "occurred as a result of the alleged misrepresentations." In other words, the injury must be shown to have been "directly attributable both to the wrongful conduct and the form and manner in which the challenged transaction occurred." Two techniques have been advanced for successfully proving loss causation: the "corrective disclosure" theory and the "materialization of the risk" theory. Under the corrective disclosure method, loss causation can be established by a corrective disclosure that surfaces a previously concealed misrepresentation or omission. The existence of a corrective disclosure followed by a decline in the price of the subject security may satisfy the loss causation requirement, as well as establish a basis for calculating damages pursuant to the PSLRA's damage calculation formula. It should be cautioned, however, that in order to be designated as a "corrective disclosure," the information, when disclosed, must "reveal some then-undisclosed fact with regard to the specific misrepresentations alleged in the complaint . . . ." It is simply not sufficient to release information that takes "a negative characterization of already-public information." While a corrective disclosure can be important in satisfying the loss causation element, it is not a sine qua non of such a showing.

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100. Many standards have been considered by the Second Circuit to prove loss causation, among them, "‘direct causation,’ ‘materialization of risk,’ and ‘corrective disclosure.’" In re Initial Pub. Offering Sec. Litig., 399 F. Supp. 2d 298, 303 (S.D.N.Y. 2005). However, this Note will focus only on the materialization of the risk and corrective disclosure methods, as these are the approaches that were refined in the Liberty Media and Household decisions.
103. See HAZEN HORNBOOK, supra note 3, at 171 (rev. 6th ed. Supp. 2009); see also supra Part I.C.
104. In re Omnicom Sec. Litig., 597 F.3d at 511; In re Flag Telecom Holdings Sec. Litig., 574 F.3d 29, 40 (2d Cir. 2009).
105. See In re Omnicom Sec. Litig., 597 F.3d at 512 (quoting Teacher's Ret. Sys. of La. v. Hunter, 477 F.3d 162, 187–88 (4th Cir. 2007) (holding that corrective disclosures may not be solely composed of publicly available information, merely restated in the negative)).
Proof of loss causation may also be premised on a theory of "materialization of the risk." Under this approach, plaintiffs must show that the "loss was foreseeable and caused by the materialization of the risk concealed by the fraudulent statement." Foreseeability is couched in the concept of proximate cause, which, in this context, requires the risk that caused the loss to be "within the zone of risk[s] concealed by the misrepresentations and omissions alleged by a disappointed investor." Put another way, a plaintiff must show the concealment of a risk falling within those risks foreseeably associated with the underlying fraud, as well as the materialization of that concealed risk. This reasoning is not internally inconsistent with the corrective disclosure theory. The U.S. District Court for the Southern District of New York succinctly described the distinction as follows:

Where the alleged misstatement conceals a condition or event which then occurs and causes the plaintiff's loss, it is the materialization of the undisclosed condition or event that causes the loss. By contrast, where the alleged misstatement is an intentionally false opinion, the market will not respond to the truth until the falsity is revealed—i.e. a corrective disclosure.

In sum, proving loss causation raises many of the same issues concomitant to showing the extent of plaintiff's pecuniary loss. This is largely because both elements require establishing a causal connection between the alleged fraud and its injurious effect on the value of securities. For this reason in particular, many actions have failed to survive dispositive motions during the pleading stage.

2006); see also In re Omnicom Sec. Litig., 597 F.3d at 511 (recognizing materialization of the risk as method of proving loss causation);
109. Lentell, 396 F.3d at 175 n.4.
111. Id. at 307.
113. Id. at 160.
114. See, e.g., McCabe v. Ernst & Young, 494 F.3d 418 (3d Cir. 2007) (affirming
III. GUIDANCE FROM THE U.S. DISTRICT COURTS FOR THE SOUTHERN DISTRICT OF NEW YORK AND NORTHERN DISTRICT OF ILLINOIS

Liberty Media and Household help clarify what plaintiffs are required to show to prove loss causation and damages at trial. These decisions also illustrate the wide “latitude afforded to juries in assessing expert testimony and awarding damages when the impact on the stock price cannot be determined with mathematical precision—which, given the complex fact patterns involving multiple misrepresentations made over many months or years that are typical of securities actions, is commonly the case.”

A. Factual Background: In re Vivendi Universal, S.A. Sec. Litig.

In re Vivendi Universal, S.A. Sec. Litig. (Vivendi Class Action) consists of a series of actions brought against Vivendi Universal, S.A. (Vivendi) for violations of § 10(b) and Rule 10b-5 thereunder. Specifically, the Vivendi Class Action was brought by U.S. and foreign shareholders of Vivendi who alleged that they purchased American Depository Receipts at “artificially inflated prices as a result of [Vivendi’s] material misrepresentations and omissions between October 30, 2000 and August 14, 2002 . . . .” In October 2009, the Vivendi Class Action was tried before a jury, resulting in a verdict for plaintiffs as to the alleged fifty-seven misstatements.

Following the Vivendi Class Action, a private suit was commenced against Vivendi in which Liberty Media Corporation alleged similar violations of the federal securities laws with respect to twenty-five of the fifty-seven misrepresentations and omissions at issue in the Vivendi Class Action. Vivendi was collaterally estopped from

summary judgment for failure to establish loss causation); Tricontinental Indus. v. PricewaterhouseCoopers, 475 F.3d 824 (7th Cir. 2007) (dismissing for failure to allege loss causation); In re Saxton Sec. Litig., 156 Fed. App’x 917 (9th Cir. 2005) (dismissing for failure to allege loss causation).
115. Damages at Trial, supra note 10.
118. Liberty Media, 923 F. Supp. 2d at 515.
119. Id.
contesting any component of the Rule 10b-5 cause of action except for the elements of loss causation and damages.\textsuperscript{120} On June 25, 2012, the jury returned its verdict in \textit{Liberty Media}, finding Vivendi liable, \textit{inter alia}, for violating § 10(b) and Rule 10b-5.\textsuperscript{121} The jury subsequently awarded Liberty Media roughly €765 million in damages.\textsuperscript{122}

Vivendi then moved pursuant to Rules 50(b) and 59 of the Federal Rules of Civil Procedure for a judgment as a matter of law, or for a new trial, respectively.\textsuperscript{123} Both motions were denied in their entirety, providing grounds for the espousal of the following principles.\textsuperscript{124}

\textbf{B. Disaggregation of Non-Fraud-Related, Price-Influencing Factors}

Before \textit{Liberty Media}, it was generally accepted that every materialization event window contained at least one confounding event.\textsuperscript{125} That is, for every time period allegedly containing fraudulent activity, courts have suspected the presence of at least one material market factor that played a role in inflating or deflating the price of the subject security. Indeed, a jury presentation that did not remove extraneous market factors would “be excluded because it misleadingly suggests to the jury that a sophisticated statistical analysis proves the impact of defendants’ alleged fraud on a stock’s price when, in fact, the movement could very well have been caused by other information released to the market on the same date.”\textsuperscript{126}
In *Liberty Media*, however, the court adopted the proposition that a confounding event is not necessarily present within every materialization window.\(^{127}\) During the *Liberty Media* litigation, plaintiffs’ expert, Dr. Blaine F. Nye, opined that over a nine-day span (the alleged “materialization window”) all of the material negative returns resulted directly from the defendant’s misconduct.\(^{128}\) Because Dr. Nye concluded that on “those days . . . everything had to do with the fraud,” Dr. Nye did not exclude a single confounding event from his damage calculation, ultimately opining that plaintiffs suffered approximately €842 million in damages.\(^ {129}\)

Vivendi challenged Dr. Nye’s disaggregation analysis, arguing that it “was so flawed as to be legally insufficient to support the jury’s verdict on loss causation and damages.”\(^ {130}\) The court disagreed and held that “Dr. Nye’s testimony was a matter for the jury, and neither legal precedent nor common sense compels the conclusion that every set of materialization event windows, no matter how small in number, must contain at least one confounding event.”\(^ {131}\) The *Liberty Media* court further noted that the jury’s award of €765 million could be upheld, at least in part, as discounting Dr. Nye’s €842 million damage figure for extrinsic market factors that were not factored into Dr. Nye’s analysis.\(^ {132}\) In other words, given that the jury’s verdict constituted a fraction of Dr. Nye’s total figure, the crux of this portion of the *Liberty Media* decision is that even if a plaintiff’s expert were to improvidently exclude confounding events from a total damages estimate, the verdict would nevertheless survive a motion for judgment as a matter of law or a new trial, as the reduced award “can be appropriately rationalized as an exercise in disaggregation of non-fraud-related factors affecting the stock price.”\(^ {133}\)

Therefore, once a plaintiff’s expert is qualified,\(^ {134}\) the jury is afforded wide discretion in assessing the expert’s testimony and

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\(^{127}\) *Liberty Media*, 923 F. Supp. 2d at 520.

\(^{128}\) Id. at 518.

\(^{129}\) Id. at 519.

\(^{130}\) Id.

\(^{131}\) Id.

\(^{132}\) Id. at 531.

\(^{133}\) *Damages at Trial*, supra note 10.

\(^{134}\) *See supra* note 76 and accompanying text.
awarding damages when the fraudulent impact on a security’s price is not capable of precise mathematical measure. It should be cautioned, however, that a potential consequence of this Second Circuit approach is that it may encourage unscrupulous experts to testify that the subject materialization event window was free of non-fraud-related factors, passing the task to the jury to arbitrarily reduce the expert’s strategically inflated damages figure by an amount equal to its perceived incredibility of the expert.

C. Leakage Theory of Proving Loss Causation and Damages

As explored above, plaintiffs have generally been confined to proving loss causation by showing a “materialization of the risk” or a “corrective disclosure.” Many courts take the position that if a part of the decline in a company’s stock precedes a corrective disclosure, that portion of the decline is excluded from the potential damage calculus. In fact, many actions are dismissed if loss causation is premised on pre-corrective disclosure revelations.

Liberty Media and Household advance a separate but related technique for proving loss causation. The “leakage theory,” which is receiving an increasing amount of acceptance and support from economists and courts alike, is premised on a “gradual exposure of

135. See generally Damages at Trial, supra note 10.

136. See supra Part I.E.

137. In re Cornerstone Propane Partners Sec. Litig., No. 03-2522, 2006 WL 1180267, at *8 (N.D. Cal. May 3, 2006) (citing Dura Pharm. v. Broudo, 544 U.S. 336, 342 (2005)) (excluding from the class any individuals who purchased and sold stock prior to any corrective disclosures that were released by the company).

138. See, e.g., D.E.& J. Ltd. v. Conaway, 133 F. App’x 994, 999 (6th Cir. 2005) (dismissing suit because plaintiff “failed to describe ‘the causal connection … between the loss and the misrepresentation.’’); In re Daou, 411 F.3d 1006, 1027 (9th Cir. 2005) (holding that information disseminated before corrective disclosure was not sufficient to establish loss causation before the corrective disclosure date).

139. See Silversman v. Motorola, 259 F.R.D. 163, 170 (N.D. Ill. 2009) (providing support for the leakage theory and noting that it has not been rejected by the Second Circuit); see also Bradford Cornell & R. Gregory Morgan, Using Finance Theory to Measure Damages in Fraud on the Market Cases, 37 UCLA L. REV. 883, 905-06 (1990) (noting that if information leaks out in advance of a public announcement, any residual model will
the fraud rather than a full and immediate disclosure"—as is the case with a corrective disclosure.140

Historically, many circuits adopted a restrictive view of the leakage theory, requiring plaintiffs to show "some mechanism for how the truth was revealed" prior to the corrective disclosure141 and how the leaked information revealed the truth with respect to the concealed fraud.142 The Tenth Circuit in the matter of Williams Securities Litigation143 held that a plaintiff cannot simply prove loss causation by stating that "the market had learned the truth by a certain date and, because the learning was a gradual process, attribute all prior losses to the revelation of the fraud."144 Rather, plaintiff must show how and when the information leaked into the market, as well as any consequential effect on the price of the underlying security.145

The U.S. District Court for the Southern District of New York took a more liberal approach in Liberty Media when it upheld plaintiffs' loss causation presentation based on the leakage theory. The plaintiffs, again through their expert, contended that news of an unfavorable credit rating prematurely affected the price of the security when it entered the market before the official, public announcement was released.146 In embracing the leakage theory, the Liberty Media court held that plaintiffs satisfied the loss causation requirement when (a) its expert testified, "based on his general expertise regarding trading, that it is easy and common for information to leak into the market before an official announcement," and (b) because Vivendi's expert was "unable to identify any specific alternative cause for the decline in Vivendi's

understate the economic importance of the underlying event).


142. Id. at 1139; Michael J. Kaufman, Securities Litigation: Damages, The Supreme Court's Interpretation of Loss Causation Under the Private Securities Litigation Reform Act of 1995D: Dura Pharmaceuticals v. Broudo And the Evolving Scope of Loss Causation, 26 SEC. LIT.

DAMAGES § 11A:15.10 (2012) (stating that the Fifth and Tenth Circuits have "taken a restrictive view on multiple disclosures, requiring that the plaintiff prove it is more probable than not that it was the fraud, and not the other contents in the corrective disclosures, that caused a significant amount of the stock price's decline.").

143. 558 F.3d 1130 (10th Cir. 2009).

144. Id.

145. Id. at 1138-39.

As a result, the court was convinced that the jury could have reasonably concluded that the pre-announcement "share decline more likely than not resulted from leaked information concerning the Moody's downgrade." 148

Similarly, in Household, plaintiff-shareholders alleged, inter alia, that Household made numerous fraudulent misrepresentations, which concealed its predatory lending practices. 149 During the materialization window, information revealing Household's predatory lending practices and improper accounting methods leaked into the public domain. 150 As a result, plaintiffs' expert testified that the corrective disclosure model did not accurately portray plaintiffs' injury because it did not take into account these pre-disclosure releases. 151

At the conclusion of trial, a jury returned a verdict in favor of plaintiffs for a subset of the alleged § 10(b) and Rule 10b-5 claims. 152 The defendants then asked the court to reject plaintiffs' expert's leakage model of proving loss causation, arguing that this model failed to establish loss causation. 153 In rejecting the defendants' motion, the court acknowledged the fundamental underpinnings of the leakage theory and declined to force plaintiffs to approach loss causation on a misstatement-by-misstatement basis. 154 It was within the jury's discretion, according to the court, to credit a damage theory that most reasonably estimates plaintiffs' damages. 155 Like the Liberty Media decision, the court emphasized that it is up to the jury to determine a proper damages award "as long as such an award has a reasonable basis in the evidence." 156

Although not enshrined in an official opinion, the Supreme

147. Id. at 523.
148. Id. at 523.
150. Id. at *2.
151. Matthew L. Mustokoff & Margaret E. Onasch, Proving Securities Fraud at Trial, REV. OF SEC. & COMMODITIES REG., June 2013, at 152 (quotations omitted) [hereinafter Proving Securities Fraud at Trial].
153. Id. at *2.
156. Id. at *2.
Court is privy to the theoretical underpinnings of the leakage theory. During oral arguments in Dura Pharmaceutical v. Broudo, the Court acknowledged that a previously concealed fraud “might come out in many different ways[,]” not only “because [the defendant] announces, I am a liar.”

Perhaps this statement is prophetic, forewarning against any future challenge to the leakage theory’s viability as an avenue for proving loss causation and damages. Nonetheless, when considering the paucity of cases discussing the issue, Liberty Media and Household provide valuable discussion as to what precisely is required to satisfy loss causation under the leakage theory. That is, once an expert is properly qualified and introduces the model in a damage presentation, it will be up to opposing counsel to discount the model or, alternatively, introduce a different model for the jury’s consideration.

**D. Maintenance Theory of Inflation**

In a case involving a material misrepresentation, “artificial inflation [of the security price] is presumed to dissipate when the false information is publicly corrected.” As a result, plaintiffs have traditionally been required to “identify particular ‘disclosing events’ that corrected the false information, and tie dissipation of artificial price inflation to those events.”

Because the disclosing event depresses the price of the security, so the argument goes, the false information, which was injected into the market prior to the disclosing event, caused plaintiff’s loss, providing grounds for establishing loss causation. Problems arise in this context when the alleged fraud involves “multiple, related but non-concurrent misrepresentations which inject inflation into a security’s price over time.” Generally, absent the availability of proving loss causation by the materialization of the risk method, plaintiffs are required to identify a “disclosing event” for

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158. Transcript at Oral Argument at 38, Dura Pharm., 544 U.S. at 336 (No. 03-932) (statements of Justice John P. Stevens); Proving Securities Fraud at Trial, supra note 151, at 153, n. 42.
160. Id.
161. See id.
163. See supra Part I.E. The “materialization of the risk” method has not been adopted.
each false statement in order to satisfy the loss causation requirement of a Rule 10b-5 cause of action.  

In contrast, in cases involving market manipulation, because the manipulative conduct has a different inflationary effect on a security’s price, a plaintiff’s burden is somewhat lessened. The generation of artificial demand, for instance, “is often secretive and difficult for an investor to detect.” This presents an interesting dichotomy: misrepresentations, by providing untrue information to the public, have an unimpeded effect on investors’ beliefs, whereas market manipulation reaches the investing public through “circumstantial evidence that positive information has [already] entered the market.” The court in the matter of Initial Public Offering provides a helpful hypothetical to illustrate. Imagine a situation where an underwriter manipulates the market by purchasing and selling securities in a series of fictitious trades motivated solely by its desire to make other investors believe that the trading volume for the security is higher than in reality. This appearance of active trading may attract investors and artificially increase the market price of the security. Once the fictitious trading ends, however, the ordinary trading by the investing public will continue, and the appearance of active trading may continue to affect the price of the security for an extended period of time. For this reason, many courts give plaintiffs flexibility in their methods of alleging market manipulation, in recognition of how challenging it can be for plaintiffs to detail the manipulation “with great particularity.”

In cases involving multiple, non-concurrent misrepresentations over an extended period of time, federal courts are beginning to

by all federal circuits. Indeed, the Second Circuit appears to be the only circuit to expressly embrace this method.

166. Id. at 579.
167. Id. at 580.
170. Id.
171. Id.
172. Id.
embrace yet another theory of showing loss causation, which in many ways rests on the same rationalization for permitting loosened pleading requirements for market manipulation plaintiffs. This theory—the “maintenance theory” of inflation—does not require plaintiffs to “prove that the statement either caused in the first instance, or increased, artificial inflation of a company’s stock price, but simply that the statement, by confirming prior misstatements, maintained pre-existing inflation caused by those earlier misstatements.”

During the course of the Vivendi litigation, the U.S. District Court for the Southern District of New York became a member of the growing assemblage of federal courts to adopt this theory. Following the Vivendi Class Action trial, Vivendi launched a post-trial attack on plaintiffs' establishment of loss causation. Vivendi asserted that liability should not attach for days which showed no increase in inflation. In rejecting this argument, the court stated that many courts have found that a “misstatement may cause inflation simply by maintaining existing market expectations, even if it does not actually cause the inflation in the stock price to increase on the day the statement is made.” The court underscored the notion that in securities fraud cases, plaintiffs need not allege each statement’s effect on investor losses with “mathematical precision.” If a plaintiff were required to quantify the precise amount of the rise in inflation due to each repeated misstatement, it would create a situation where expert witnesses, though useful in assessing such manipulation, would be unable to identify the degree of inflation caused by each misstatement individually. Thus, in a case where a defendant repeatedly makes statements that reinforce its prior misstatements (e.g., Vivendi’s repeated statements reinforcing its liquidity position), courts find it acceptable to conclude that every

174. Mustokoff & Onasch, supra note 162 (emphasis added).
175. See id.
177. Id. at 561.
178. Id. (citing Castillo v. Envoy Corp., 206 F.R.D. 464, 472 (M.D. Tenn. 2002)).
179. Id. at 562.
180. Id. at 562 (“Such a rule could permit a company to avoid Section 10(b) liability by repeating its misstatements so many times that it becomes impossible for an expert to prove that any particular misstatement, viewed in isolation, caused a quantifiable increase in inflation.”).
misstatement provided to the public resulted in artificial inflation of the stock price, regardless of whether the exact proportion of loss caused to investors can be attributed to any particular misstatement.\footnote{Id. at 562.}

The \textit{Liberty Media} court implicitly\footnote{The \textit{Liberty Media} court implicitly accepted the maintenance theory of inflation by justifying its holding with the reasoning supporting the theory but without expressly adopting it by title. Also, Judge Scheindlin, near the end of the court's order, stated that, "Either way, plaintiffs may suffer the same losses as a result of the materialization of the risk." Liberty Media v. Vivendi Univ., 923 F. Supp. 2d 511, 526 (S.D.N.Y. 2013). This perhaps suggests that the court employed the reasoning of the maintenance theory of inflation, but mistakenly labeled it as the materialization of the risk theory.} recognized this theory in the subsequent deconsolidated trial. Following the jury verdict, Vivendi argued that plaintiffs' expert's testimony in separate trials to the same amount of inflation for different sets of misstatements discredited his damages presentation, rendering any jury reliance thereon unreasonable.\footnote{Liberty Media, 923 F. Supp. 2d at 524-25. At the \textit{Vivendi} Class Action trial, plaintiffs alleged fifty-seven counts of fraudulent conduct compared to the twenty-five claims at issue in the \textit{Liberty Media} trial. \textit{Id.} A merger agreement limited plaintiffs' allegations to a certain time period, which allegedly contained twenty-five misrepresentations. \textit{Id.}}

The \textit{Liberty Media} court was not persuaded, holding that the expert's damages presentation did not rely on the "assumption that every misrepresentation by Vivendi could be independently monetized and subtracted from Liberty's damages."\footnote{Id. at 525.} Quite the opposite, the expert presented a narrative that supported a constant growth of inflation over an extended period of time.\footnote{Id.} The court reminded the defendant that it was able throughout the trial to try to convince the jury that plaintiffs' expert's analysis was overly simplistic, and that a more complex model was appropriate under the circumstances; however, the court also explained that damages need not be proven with "mathematical certainty," but rather only by adequate evidence for a juror to make a "reasonable estimate of damage[s]."\footnote{Id. at 525-26.} Thus, the court concluded that plaintiffs' expert had presented sufficient evidence for the jury to make a reasonable estimate of damages, which ultimately amounted to approximately \euro765 million.\footnote{Id. at 530.}
IV. Conclusion

The prime desideratum of loss calculation is to compensate the defrauded plaintiff for damages directly resulting from defendant’s wrongful act. But requiring securities fraud plaintiffs to prove loss causation and damages with mathematical certainty would create a particularly perverse result. *Liberty Media* and *Household* therefore suggest that “juries are, by and large, given leeway to ascribe rough proportions of shareholders’ losses to the fraud based on credibility determinations concerning the expert testimony on disaggregation and are not themselves required to perform the kind of sophisticated, technical calculations carried out by experts.” Though a delegation to the jury box, this approach complies with § 28(a) of the 1934 Act and the Private Securities Litigation Reform Act of 1995 by mandating the removal of extraneous market factors from the loss calculation measure, limiting losses to those actually caused by defendant’s unlawful conduct.

In addition, *Liberty Media* and *Household* arm courts with a formula tethered to economic theory and a defendant’s culpability through their endorsement of the leakage theory of corrective disclosure and the maintenance theory of inflation. These methodologies provide practitioners with a consistent framework for proving loss causation and damages in those increasingly common situations involving pre-corrective disclosure revelations of the underlying fraud or when non-concurrent, compound misrepresentations are made over an extended period of time, respectively.

S. Austin King

188. *Damages at Trial, supra* note 10.