THE RULE 10b-5 SUIT: LOSS CAUSATION PLEDGING STANDARDS IN PRIVATE SECURITIES FRAUD CLAIMS AFTER DURA PHARMACEUTICALS, INC. v. BROUDO

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In 2005, the U.S. Supreme Court decided Dura Pharmaceuticals, Inc. v. Broudo. The Court held that a plaintiff alleging securities fraud must prove that a defendant’s misrepresentation caused actual economic loss. The Dura decision put to rest the loss causation standard applied by several U.S. courts of appeals, which allowed plaintiffs to merely plead that a misrepresentation caused an artificially inflated purchase price. However, in Dura’s wake, the circuit courts have fashioned divergent standards with respect to pleading loss causation. The courts currently apply pleading standards ranging from the lenient and generally applicable Federal Rule of Civil Procedure 8(a) to the stringent and fraud-specific Rule 9(b). This Note analyzes the various loss causation pleading standards applied by the circuit courts and urges the Supreme Court to adopt the standard developed by the U.S. Court of Appeals for the Second Circuit. The Second Circuit’s loss causation pleading standard should be adopted because its two-part test ensures that only claims alleging a close connection between loss and misrepresentation survive pleadings, yet refrains from adopting a heightened standard unsupported by Congress or Supreme Court precedent.

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**INTRODUCTION**

It’s the little suit that made Bill Lerach . . . famous, scads of plaintiffs lawyers rich, and more than one corporate general counsel wonder why he ever went to law school in the first place. It’s the securities class-action lawsuit, specifically, the ‘10b-5’ suit . . . .

The Securities and Exchange Commission (SEC) Rule 10b-5 suit is the foremost investor protection tool available to those who have been cheated in the securities marketplace. Rule 10b-5 is typically invoked by class action plaintiffs against a defendant with whom the plaintiffs have invested significant funds. A basic factual scenario giving rise to a Rule 10b-5 claim may appear as follows: Corporation X reports that it sells 100 widgets every month. Corporation X’s stock price is high. Investors, encouraged by reported widget sales, buy millions of dollars worth of Corporation X stock. It is then revealed that Corporation X misrepresented true widget sales, which had in actuality been only ten widgets per month. Corporation X’s stock price plummets and investors lose millions. The investors now have a Rule 10b-5 claim against Corporation X for securities fraud. To prevail, the plaintiff investors must prove that Corporation X’s misrepresentation caused their economic loss. Here, the cause of the plaintiffs’ loss is obvious: when Corporation X’s misrepresentation became public, the market responded by correcting what was before an inflated stock price. However, as the facts become more complicated, the answer to the loss causation question becomes less clear. Suppose all industry participants competing with Corporation X saw an identical stock price drop. Was the plaintiffs’ loss caused by the misrepresentation or industry-wide market effects? Alternatively, suppose Corporation X sells many widgets and had misrepresented sales for some widgets, but not those on which the plaintiffs relied when purchasing Corporation X stock. Can the plaintiffs claim Corporation X misrepresented its goodwill, rather than widget sales, and caused loss when it was revealed that Corporation X was in fact run by scoundrels? Or perhaps plaintiffs instead sue the investment analyst who recommended Corporation X stock as a red-hot buy. It later turns out that the analyst misrepresented the stock risk because his banking firm was also Corporation X’s underwriter. Has the analyst caused the plaintiffs’ loss?

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3. See infra Part I.B (discussing the history of the Securities and Exchange Commission (SEC) and Rule 10b-5 in particular).
4. See infra Part II (analyzing securities fraud cases where the plaintiffs are predominately investors suing the entities with which they have invested funds).
Whether suits bearing these difficult loss causation questions ever have an opportunity to go to trial (or more likely, to settle) depends on the pleading standard. The U.S. Supreme Court’s 2005 decision in *Dura Pharmaceuticals, Inc. v. Broudo* held that a plaintiff must establish loss causation by proving an actual economic loss. The Court did not, however, establish a loss causation pleading standard. In *Dura’s* wake, the U.S. courts of appeals have fashioned divergent pleading standards based on their individual readings of *Dura*. This Note discusses the range of pleading standards currently applied by the circuit courts to the loss causation element of the Rule 10b-5 suit.

The foundations of the loss causation pleading problem lie in the Securities Act of 1933 (‘33 Act) and the Securities Exchange Act of 1934 (‘34 Act). The ‘33 Act delineates the process of securities distribution, while the ‘34 Act relates to securities exchanges on the open market. The Acts were passed in response to the financial turmoil that enveloped the nation during the Great Depression. While the Acts provided express private causes of action for plaintiffs, judicially developed implied actions have done the most to enforce their provisions.

The most frequently litigated securities actions fall under section 10(b) of the ‘34 Act and Rule 10b-5. Litigation under these provisions is particularly prevalent because they are “the so called ‘catchall’ fraud provision[s]” that broadly “prohibit the making of false and misleading statements or omissions in connection with the purchase and sale of securities.” Violations of these provisions include fraud based on corporate finances, the riskiness of investments, and the market viability of new products.

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7. 544 U.S. 336.
8. Id. at 346–47.
9. See infra Part I.E.3 (discussing the U.S. Supreme Court’s deficient treatment of loss causation).
10. See infra Part II (identifying the various loss causation pleading standards developed by the U.S. courts of appeals in light of unclear guidance from the Supreme Court).
13. See Loss & Seligman, supra note 12, at 38.
15. See infra Part I.C (discussing the development of implied civil liabilities under the ‘34 Act).
19. See ATSI Commc’ns, Inc. v. The Shaar Fund, Ltd., 493 F.3d 87, 95–96 (2d Cir. 2007).
One of the crucial developments in securities law of recent vintage is the Private Securities Litigation Reform Act of 1995 (PSLRA). Among other things, the PSLRA clarified that heightened pleading standards must apply for only two specific elements of a private securities fraud claim: material misrepresentation and scienter. This Note focuses on loss causation, an essential element to securities fraud claims that Congress explicitly codified in the PSLRA. Unlike material misrepresentation and scienter, however, Congress failed to specify a pleading standard for loss causation.

Having been excluded from the explicit mandates of the PSLRA, the pleading standard applied to loss causation differed among the circuit courts. The Supreme Court finally considered the loss causation pleading standard problem in *Dura*. Framing loss causation in light of fraud common law, the original purpose of the '33 and '34 Acts, the mandates of the PSLRA, and various circuit court decisions, the *Dura* opinion did little to establish anything close to a concrete loss causation pleading standard.

The shortcomings of *Dura* are exemplified by the various loss causation pleading standards currently applied by the circuit courts. These standards range from the easily met and generally applicable Federal Rule of Civil Procedure (FRCP) 8(a) to the narrow, fraud specific, FRCP 9(b).

Part I of this Note discusses the background of the '33 and '34 Acts and outlines the overall purpose and goals of securities law. This part also

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23. *Hunter*, 477 F.3d at 172; see infra Part I.D.2. To satisfy the element of scienter, a plaintiff must show that the defendant acted with the requisite intent or state of mind. *Hunter*, 477 F.3d at 172.
25. See id.; *Hunter*, 477 F.3d at 185.
27. Id.
29. See infra Part II (identifying a range of loss causation pleading standards, from flexible to stringent, currently applied by the circuit courts).
30. FRCP 8(a) merely requires a plaintiff to submit a “short and plain statement of the claim showing that the pleader is entitled to relief.” FED. R. CIV. P. 8(a)(2).
31. FRCP 9(b) requires that a plaintiff “state with particularity the circumstances constituting fraud.” FED. R. CIV. P. 9(b).
considers the overactive securities plaintiffs’ bar that arose because of the broad language and absence of private claim provisions in the Acts. Following this discussion is an analysis of Congress’s response to the rise in frivolous securities suits through its enactment of the PSLRA. The particular problem of loss causation pleading remaining in light of the PSLRA and Dura is also framed.

Part II explores the circuit split that has arisen since Dura with respect to loss causation pleading. The various loss causation standards applied by the U.S. Courts of Appeals for the Second, Fourth, Fifth, Seventh, and Ninth Circuits are identified. The problems that this split poses with respect to the concerns addressed by Congress’s enactment of the PSLRA are also discussed.

Part III compares and analyzes the loss causation standards applied by the various circuits. This inquiry identifies the stringency of each standard. As part of this analysis, each circuit’s interpretation of Dura and loss causation is evaluated in terms of its relation to the overall goals of securities fraud litigation and, in particular, the concerns addressed by the PSLRA. Finally, this Note argues that the Supreme Court should adopt the two-part loss causation standard applied by the Second Circuit. The Second Circuit requires plaintiffs to plead that the loss suffered was foreseeable and within a zone of risk concealed by the misrepresentation. This standard is preferable for three reasons. First, and most importantly, the test is most clearly in line with the Supreme Court’s decision in Dura and congressional intent in passing the PSLRA to minimize frivolous securities lawsuits. Second, Congress used the pleading standards of the Second Circuit as a guide when passing the PSLRA. Third, the test’s foreseeability requirement ensures that if a risk is otherwise concealed and causes harm, a defendant will only be held liable for losses foreseeably caused by its actions.

I. THE SECURITIES LAWS, LOSS CAUSATION, AND DURA PHARMACEUTICALS, INC. V. BROUDO

The role played by the loss causation element in private securities fraud claims can be best understood when put in context of the purpose and history of securities law as a whole. Part I provides background information on U.S. securities law, beginning with the cornerstones: the ’33 and ’34 Acts. Section 10(b) of the ’34 Act outlaws deceptive practices in securities trading and is the primary statutory basis for the suits considered in this Note. Next, Rule 10b-5, adopted pursuant to the ’34

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32. The remaining circuits have not directly ruled on the loss causation pleading standard.
33. See infra Part III.A (advocating that the Supreme Court adopt the U.S. Court of Appeals for the Second Circuit’s loss causation pleading standard).
34. See infra notes 99–101 and accompanying text.
35. See infra Part III.A.
Act as a measure to enhance enforcement of section 10(b), is introduced. The evolution of the private cause of action available to investors under section 10(b) and Rule 10b-5 is also discussed. This is followed by a brief examination of the most recent congressional mandate affecting private securities fraud claims: the PSLRA. Finally, the Supreme Court decision in *Dura* is analyzed in detail in order to isolate the loss causation problem that this Note subsequently addresses.

A. The Securities Act of 1933 and the Securities Exchange Act of 1934

The events leading up to and rationale behind the codification of the first U.S. securities statutes are the starting point of today’s securities laws. The decade preceding the Great Depression saw unprecedented growth in securities underwriting, valuation, and trading. As securities prices rose, successful businesses quickly began to issue greater numbers of securities. Accumulated funds from securities issuance found their way back into the market through brokers’ loans, which facilitated further transactions. This snowball effect resulted in continually increasing capital in securities markets, which markedly increased investor participation. As trading in securities became ever more profitable, investors engaged in increasingly risky transactions, while issuers exercised little due diligence in security valuation and risk disclosure. Amateur investors engaged in extensive securities speculation, investing borrowed money in securities they knew little about. Once the excessive speculative trading reached its breaking point and the Great Depression gripped the national economy, Congress, as well as the overwhelming majority of industry participants, called for legislative intervention.

One of the major issues under scrutiny for legislative reform was the actual practice of issuing securities. Issuers such as investment trusts and utilities had been suspected of engaging in careless and abusive underwriting, where excessive securities were purposely issued, minimal...
information was disclosed to the public, and the information disclosed was either false or unsupported by actual findings.\textsuperscript{46} The investing public suffered severe economic loss through its heavy dealing with what were in fact securities of very high risk.\textsuperscript{47} President Franklin D. Roosevelt’s message to Congress, delivered soon after his first election, reflected the scope of the reform required: “This proposal adds to the ancient rule of caveat emptor, the further doctrine, ‘let the seller also beware.’ It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.”\textsuperscript{48} To that end, Congress passed the ’33 Act with the overriding purpose of protecting investors.\textsuperscript{49} The Act was intended to decrease opportunism and fraud by mandating extensive seller disclosure prior to stock issuance and providing for both civil and criminal liability for its violation.\textsuperscript{50} In order to protect investors after the issuance of a security, Congress passed the ’34 Act.\textsuperscript{51} The ’34 Act protects investors by requiring securities issuers to conduct periodic disclosures after their securities have entered the market.\textsuperscript{52}

B. \textit{Section 10(b) of the ’34 Act and SEC Rule 10b-5}

Section 10(b) of the ’34 Act is the foremost antifraud provision in U.S. securities law and is utilized through its primary mechanism of enforcement, SEC Rule 10b-5. Section 10(b) broadly prohibits deceptive and fraudulent security practices that are in violation of an SEC Rule.\textsuperscript{53} Thus, section 10(b) provides the foundation for implied private securities fraud claims.\textsuperscript{54} Section 10(b), titled “Manipulative and deceptive devices,”\textsuperscript{55} states the following:

\begin{quote}
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may
\end{quote}

\textsuperscript{46} See id. at 19.
\textsuperscript{47} See id. at 20.
\textsuperscript{48} 77 Cong. Rec. 937 (1933) (statement of President Franklin D. Roosevelt).
\textsuperscript{50} See McCormick, supra note 37, at 24–25.
\textsuperscript{51} See Loss & Seligman, supra note 12, at 38; Schanbaum, supra note 49, at 186.
\textsuperscript{52} See Loss & Seligman, supra note 12, at 38. In addition to periodic disclosures, the ’34 Act also requires disclosures in other contexts where investor knowledge is essential, such as corporate proxy contests and tender offers. See id.
\textsuperscript{55} 15 U.S.C. § 78j.
Section 10(b) explicitly vests the SEC with the power to create rules to enforce section 10(b)’s prohibitions. The SEC exercised this power in 1942 through its adoption of Rule 10b-5. Rule 10b-5 is one of the most important and widely used rules promulgated by the SEC. Rule 10b-5, titled “Employment of manipulative and deceptive devices,” states the following:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-5 broadly prohibits the deceptive activity mentioned in section 10(b), in fact to such an extent that Rule 10b-5 has been referred to as a “long-arm provision in which the SEC forbids everything the statute gives it power to forbid.” Plaintiffs thus employ Rule 10b-5 in tandem with section 10(b) when alleging securities fraud.

C. Private Causes of Action for Violations of Section 10(b) and Rule 10b-5

This section considers the use of section 10(b) and Rule 10b-5 by private plaintiffs and introduces the judicially developed rubric for evaluating these claims. The ’34 Act is used to protect investors through its express

56. Id.
57. Id.; see Schanbaum, supra note 49, at 187; see also Gordon, supra note 44, at 65 (“Under the authority of Section 10(b), the Securities and Exchange Commission promulgated Rule 10b-5.”). The SEC is also empowered to enforce other sections of the ’34 Act, as well as the prohibitions of the ’33 Act. See, e.g., LOSS & SELIGMAN, supra note 12, at 37 (“The SEC currently administers . . . the Securities Act of 1933 [and] the Securities Exchange Act of 1934 . . . .”); see also McCormick, supra note 37, at 28 (“[The SEC] is empowered to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of the [’33 Act].”).
59. See Thel, supra note 14, at 463. Although now a prominent and well-defined weapon in the SEC’s armory, Rule 10b-5 was drafted and passed in a single day as a hasty response to a particular corporate misrepresentation. See, e.g., LOSS & SELIGMAN, supra note 12, at 840; Schanbaum, supra note 49, at 187.
60. 17 C.F.R. § 240.10b-5 (2009).
61. Id.
62. Thel, supra note 14, at 463.
provisions as well as through implied grounds for civil liability. Implied civil liabilities have historically provided the strongest means of investor protection under the '34 Act. Although some commentators have expressed doubt as to whether Congress intended various implied liabilities to exist under the Acts, courts have long held that the validity of implied liabilities for violating section 10(b) of the '34 Act and Rule 10b-5 is beyond doubt.

Section 10(b) and Rule 10b-5, while explicitly prohibiting deceptive securities practices, provide little guidance as to how courts should evaluate claims alleging their violation. For this reason, the elements required to prove section 10(b) and Rule 10b-5 violations are almost entirely judicially constructed. Implied civil liability under section 10(b) and Rule 10b-5 has developed to closely resemble a common-law tort claim: “[t]he courts have implied from these statutes and Rule a private damages action, which resembles, but is not identical to, common-law tort actions for deceit and misrepresentation.” The Supreme Court has specified the following elements of a securities fraud claim under section 10(b) and Rule 10b-5: (1) a material misrepresentation or omission, (2) scienter, (3) a connection with the purchase or sale of a security, (4) reliance (transaction causation), (5) economic loss, and (6) loss causation.

64. See LOSS & SELIGMAN, supra note 12, at 1105. Express civil liabilities available to plaintiffs for assertion against '34 Act violators can be found in sections 9(e), 16(b), 18, and 29(b) of the '34 Act. See id. at 1162. Before the passage of the Acts, “there was no way for the federal government to deal with securities fraud except by criminal prosecution for violating the mail fraud statute.” Id. at 837 (citing 18 U.S.C. § 1341 (2006)).

65. See id. at 1169–70.

66. See, e.g., Gordon, supra note 44, at 62–63 (arguing that because Congress explicitly created private rights of action in some sections of the Acts, private rights are not intended to attach to other sections).

67. See Herman & MacLean v. Huddleston, 459 U.S. 375, 380 n.10 (1983) (tracing the history and expansion of implied private rights under section 10(b) and Rule 10b-5); Kardon v. Nat’l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) (“In other words, in view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies.”); LOSS & SELIGMAN, supra note 12, at 1174 (“It is now established that a private right of action is implied under §10(b).” (quoting Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971))); see also Laura D. Mruk, The Proverbial Axe to the Judicial Oak: The Impact of Stoneridge on Plaintiff's Actions Under § 10(b), 29 N. Ill. U. L. Rev. 281, 284–85 (2009) (“Despite infighting among legal scholars regarding the history and scope of rule 10b-5, it has come to be accepted as enforceable publicly through an implied right of action.”).

68. See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2006); 17 C.F.R. § 240.10b-5 (2009); see also Schanbaum, supra note 49, at 187 (“But no details were provided with respect to the elements of a Rule 10b-5 violation or the level of conduct that would constitute a violation.”).

69. See Matthew L. Fry, Pleading and Proving Loss Causation in Fraud-on-the-Market-Based Securities Suits Post-Dura Pharmaceuticals, 36 SEC. REG. L.J. 31, 33 (2008); Gordon, supra note 44, at 65; Schanbaum, supra note 49, at 187–88 (“Thus, the Supreme Court was left to determine the ultimate extent of section 10(b) by examining the statute in the context of the Securities Acts as a whole.”).


71. Id. at 341–42; see Ann Morales Olazábal, Loss Causation in Fraud-on-the-Market Cases Post-Dura Pharmaceuticals, 3 BERKELEY BUS. L.J. 337, 343 (2006).
D. Loss Causation: From Judicial Development to Codification in the Private Securities Litigation Reform Act of 1995

This section briefly discusses the history of loss causation and its role as an element of private securities fraud claims. The history of loss causation is traced from its ad hoc development by the courts to its codification by Congress in 1995. Additionally, loss causation is distinguished from the related element of reliance, or transaction causation.

1. Judicially Developed Loss Causation and Its Relation to Transaction Causation and Reliance

As discussed previously, section 10(b) and Rule 10b-5 did little to specify how one must plead a violation.72 The causation element of a securities fraud claim is no exception and has developed through less than consistent application over many decades.73 The causation element of section 10(b) and Rule 10b-5 claims originally required a showing of causation in fact, or but-for causation, which could be satisfied by pleading reliance.74 This standard of proving causation undoubtedly reflected the guidance courts sought from well-defined common-law fraud and deceit actions.75 While courts’ interpretations of loss causation were initially based on standards for tort claims, section 10(b) and Rule 10b-5 loss causation is conceptually distinct from these standards.76

The Second Circuit in Schlick v. Penn-Dixie Cement Corp.,77 first framed causation in securities fraud cases as it stands today, in terms of both transactional causation and loss causation.78 In its decision, the court articulated its bifurcation of the causation element: “loss causation [requires] that the misrepresentations or omissions caused the economic harm—and transaction causation [requires] that the violations in question caused the appellant to engage in the transaction in question.”79 Thus, the court held, the plaintiff’s decision to enter into a securities transaction, as

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72. See supra notes 68–69 and accompanying text.
73. See Olazábal, supra note 71, at 345; Devin F. Ryan, Comment, Yet Another Bough on the “Judicial Oak”: The Second Circuit Clarifies Inquiry Notice and Its Loss Causation Requirement Under the PSLRA in Lentell v. Merrill Lynch & Co., 79 ST. JOHN’S L. REV. 485, 508 (2005) (“The indispensable element of causation under the federal securities laws was judge-made and was principally bottomed in tort law theory.”).
75. See Fry, supra note 69, at 33–34; Olazábal, supra note 71, at 339.
76. See Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341 (2005); Fry, supra note 69, at 33–34.
77. 507 F.2d 374 (2d Cir. 1974).
78. Id. at 380.
79. Id.
well as the plaintiff’s loss in connection with that transaction, must be caused by the defendant’s misrepresentation.\textsuperscript{80} 

Transaction causation mirrors the causation element as applied pre-Schlick, as a but-for causal element requiring a securities fraud plaintiff to show that if it were not for the defendant’s misrepresentation, he would not have entered into the securities transaction.\textsuperscript{81} The Supreme Court in \textit{Affiliated Ute Citizens v. United States}\textsuperscript{82} simplified transaction causation by holding that as long as the information the plaintiff relied on in entering the transaction was material, transaction causation was satisfied without more.\textsuperscript{83}

Loss causation, on the other hand, more resembles tort proximate cause.\textsuperscript{84} The conceptual difference between securities loss causation and tort proximate causation lies in why an event causes loss.\textsuperscript{85} In a securities case, the event that proximately (in the tort context) causes economic loss is a disclosure of a misrepresentation, which may take the form of a press release or government action, among other things.\textsuperscript{86} However, that disclosing event itself is not the reason the loss occurred. It is instead the underlying truth revealed by the disclosure, namely the true riskiness of a security.\textsuperscript{87}

\textsuperscript{80} Id.
\textsuperscript{81} See Fry, supra note 69, at 34–37; Mruk, supra note 67, at 301. The transaction causation requirement was particularly difficult for plaintiffs to satisfy because plaintiffs were required ex post to show they would have acted in a particular way (not have entered a deal) had they been privy to information that they were not aware of at the time. See Jill E. Fisch, \textit{Cause for Concern: Causation and Federal Securities Fraud}, 94 Iowa L. Rev. 811, 817 (2009).

\textsuperscript{82} 406 U.S. 128 (1972).

\textsuperscript{83} Id. at 153–54 (“All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.”); see Loss & Seligman, supra note 12, at 1202; Ryan, supra note 73, at 509 (“Transaction causation, or ‘but for’ causation in fact, can be equated to the common law fraud concept of reliance . . . .” (citing Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005)).

\textsuperscript{84} See Fry, supra note 69, at 33; Ryan, supra note 73, at 509 (“[L]oss causation, the far more subtle stepchild of causation, is arguably analogous to the tort concept of proximate or legal causation.”).

\textsuperscript{85} See Fry, supra note 69, at 34–35.

\textsuperscript{86} See, e.g., \textit{In re Mutual Funds Inv. Litig.}, 566 F.3d 111, 117–18 (4th Cir. 2009). The proximate cause of the plaintiffs’ loss in \textit{In re Mutual Funds Investment Litigation} was a complaint filed by the New York Attorney General against the defendants. Id. However, the plaintiffs did not allege that it was this complaint that caused the defendant’s stock price to plummet. Instead, it was the underlying misrepresentation revealed by the complaint that allegedly caused the plaintiffs’ loss. Id.

\textsuperscript{87} See Lentell, 396 F.3d at 173 (“A foreseeable injury at common law is one proximately caused by the defendant’s fault, but it cannot ordinarily be said that a drop in the value of a security is ‘caused’ by the misstatements or omissions made about it, as opposed to the underlying circumstance that is concealed or misstated.”).
2. Loss Causation Codified: The Private Securities Litigation Reform Act of 1995

The PSLRA codified the judicially determined elements of a section 10(b) and Rule 10b-5 securities fraud claim, including loss causation. This section discusses the overall intent of the PSLRA, thus giving context to later courts’ applications of loss causation, as well as Congress’s cursory treatment of the loss causation element.

The PSLRA was the congressional response to costly abuses occurring in the realm of private securities litigation.88 Litigation abuses largely arose because of uncertainty surrounding private securities fraud litigation doctrine.89 Specifically, plaintiffs’ lawyers had used securities fraud litigation opportunistically to reap large settlements for nonmeritorious claims, even when the plaintiffs themselves had little to gain.90 Suits were filed with no intention of actually litigating, but only based on settlement value.91 The bar for filing a complaint against a corporation was very low, requiring “little or no due diligence.”92 Complaints were frequently filed and quickly followed with expensive discovery requests, after publicly traded companies’ stock prices dropped or adverse earnings statements were released.93 Thus, volatile start-ups experiencing a downturn in stock price would often receive a slew of complaints alleging that the company misrepresented its true value.94 These concerns were succinctly expressed by the House Committee on Commerce when considering securities litigation reform legislation:

Today, our litigation system allows, indeed encourages, abusive “strike suits”—class actions typically brought under the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5

89. S. REP. NO. 104-98, at 4 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 683. Much of this uncertainty had arisen because of a complete lack of congressional input regarding private securities fraud actions. See supra notes 72–76 and accompanying text. Section 10(b) causes of action were wholly judicially based and varied significantly from court to court. See supra notes 72–76 and accompanying text.
90. S. REP. NO. 104-98, at 6, reprinted in 1995 U.S.C.C.A.N. at 685. Studies showed that investors often recovered approximately ten percent of their losses through settlements, purportedly because of self-interested plaintiffs’ attorneys dominating the litigation. Id.
promulgated thereunder. Strike lawsuits are lawsuits filed by class action attorneys on behalf of shareholders whose once attractive stock purchases have failed to live up to their expectations. Volatile stock prices, rapid product development, and technological changes make growing companies a target. As a result, high technology, biotechnology, and other growth companies are hardest hit.95

In order to combat these abuses, Congress passed the PSLRA with three primary goals: “(1) to encourage the voluntary disclosure of information by corporate issuers; (2) to empower investors so that—they—not their lawyers—exercise primary control over private securities litigation; and (3) to encourage plaintiffs’ lawyers to pursue valid claims and defendants to fight abusive claims.”96 The PSLRA increases plaintiffs’ control over their suits by creating a presumption that the investor-plaintiff with the greatest financial investment in the defendant corporation will be the lead plaintiff.97 The PSLRA also mandates greater disclosure involving settlement details, so investor-plaintiffs will have an opportunity to reject a settlement if it is only favorable to their lawyers.98

Of particular importance to this Note, the PSLRA took measures to establish and heighten pleading standards for alleging securities fraud.99 Specifically, Congress adopted the FRCP 9(b) pleading standard as applied by the Second Circuit, which was considered the “most stringent” with regard to securities fraud claims.100 In doing so, Congress clearly set forth Rule 9(b) as the applicable standard for the securities fraud element of scienter.101 The Second Circuit standard requires the plaintiff to “plead facts that give rise to a ‘strong inference’ of defendant’s fraudulent intent.”102

Congress also mandated that a heightened FRCP 9(b) standard be applied to the element of misrepresentation.103 “[t]he plaintiff must also specifically identify each statement alleged to have been misleading, the

99. Id. at 15, reprinted in 1995 U.S.C.C.A.N. at 694; see Seligman, supra note 91, at 105; Ryan, supra note 73, at 500–01 (“[The PSLRA] advanced Congress’s assault on strike suits by placing . . . Herculean requirements on plaintiffs pleading a cause of action under section 10(b) and Rule 10b-5 . . . .”); Sommer, supra note 93, at 423.
102. Id. (quoting In re Time Warner, Inc. Sec. Litig., 9 F.3d 259, 268 (2d Cir. 1993)). However, Congress did not go so far as to codify the body of case law of the U.S. Court of Appeals for the Second Circuit; rather, Congress made it clear that courts may only find “this body of law instructive.” Id.
103. Id.
reason or reasons why the statement is misleading, and, if the allegation is made on information and belief, the plaintiff must set forth all information in plaintiff’s possession on which the belief is formed.”

While Congress specifically required a heightened FRCP 9(b) pleading standard for scienter and misrepresentation, it was silent regarding the pleading standard required for loss causation. In fact, as discussed previously, the PSLRA was the first codification of loss causation. By passing the PSLRA, Congress bluntly required that “plaintiffs prove that the loss in the value of their stock was caused by the section 10(b) violation and not by other factors.” Thus, while the PSLRA finally codified the loss causation element, it gave little indication as to how a plaintiff may successfully allege loss causation at the pleadings stage.

E. The Seminal Case Addressing Securities Fraud Loss Causation: Dura Pharmaceuticals, Inc. v. Broudo

A thorough understanding of the Supreme Court’s only decision regarding the application of the loss causation element to private securities fraud suits in light of the PSLRA is required to effectively analyze the current circuit split. This section first reviews the substantive loss causation issue confronted by the Court in Dura before examining the decision itself. Following a review of the facts and holding of Dura, the loss causation pleading question left unanswered by the Court is introduced.

1. Loss Causation Before Dura and the Pre-Dura Circuit Split

The Dura Court addressed two opposing theories among the circuit courts regarding how a private securities fraud plaintiff must plead factual allegations to satisfy loss causation. The U.S. Courts of Appeals for the Eighth and Ninth Circuits followed what can be called the “date of purchase” pleading standard. Under this interpretation, plaintiffs may adequately plead loss causation by alleging that loss occurred at the moment that the defendant’s security was purchased. The theory is that the purchase price of the stock was artificially inflated above its “intrinsic value,” the value that the stock would truly be worth in the absence of the

104. Id.
105. See id.; Escoffery, supra note 88, at 1810 (“Unfortunately, the statute does not provide a clear analytical approach to guide courts in determining whether a plaintiff has sufficiently pled loss causation.”).
108. See supra note 105 and accompanying text.
110. See Skey, supra note 109, at 584.
111. See Fry, supra note 69, at 39; Skey, supra note 109, at 569.
defendant’s misrepresentations. Thus, the plaintiff suffers loss by paying more than this intrinsic value at the time of purchase.

The U.S. Courts of Appeals for the Second, Third, Seventh, and Eleventh Circuits rejected this view. These courts required loss pleading in addition to merely alleging an artificially inflated stock price at the time of purchase. Under this standard, the plaintiff must plead actual economic loss caused by a market correction, occurring in response to a public disclosure revealing the defendant’s misrepresentation, which in actuality decreased an inflated stock price to its intrinsic value.

2. The Facts and the Holding of Dura

In Dura, the plaintiff shareholders alleged that managers and directors of Dura Pharmaceuticals, Inc. (Dura) misrepresented future profits and the likelihood that the Food and Drug Administration (FDA) would approve Dura’s new asthmatic inhalation device. Plaintiffs purchased Dura stock on the public securities market between April 15, 1997, and February 24, 1998, after the alleged misrepresentations were made. On February 24, 1998, Dura publicly announced that its profits would be lower than previously claimed. Subsequently, in November 1998, Dura announced that the inhalation device would not gain FDA approval. Immediately after the negative announcements, Dura shares fell precipitously, resulting in plaintiffs’ stock losing almost fifty percent of its value. Plaintiffs claimed that loss occurred at the moment that they purchased Dura shares because the purchase price was artificially inflated.

The U.S. District Court for the Southern District of California dismissed the complaint for failing to sufficiently state scienter and loss causation. The Ninth Circuit reversed. With respect to loss causation, the Ninth Circuit reasoned that the shareholders only needed to plead that "the price
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on the date of purchase was inflated because of the misrepresentation.”125 The Ninth Circuit emphasized that “the injury occurs at the time of the transaction.”126 In a unanimous decision authored by Justice Breyer, the Supreme Court reversed, finding error with the Ninth Circuit’s analysis of the loss causation element of the securities fraud claim.127

The Court discussed three flaws with the Ninth Circuit’s holdings.128 First, the Court explained why the timing element of plaintiffs’ claim could not have caused a loss.129 The Court found a fundamental flaw with the Ninth Circuit’s view that the loss claimed by the plaintiffs occurred at the instant that they purchased Dura shares.130 The Court reasoned that this interpretation failed a test of “pure logic” because, at the instant an inflated stock is purchased, no loss has yet occurred, as the shareholders’ stock is still worth exactly as much as he had paid for it.131 The Court then stated that even for a time after the purchase of the stock, the stock’s value is not sure to change.132 If a shareholder buys a stock at an inflated price, waits, and then sells the stock, the shareholder will not have suffered a loss if the stock is still inflated.133 The Court reasoned that the only way a purchaser of an inflated stock could suffer economic harm was if he had sold that stock after “the truth makes its way into the marketplace.”134 Even in this situation, the defendant’s misrepresentation only “might mean a later loss. But that is far from inevitably so.”135 This is because there are many factors that affect a stock’s value in the marketplace, the revelation of a misrepresented truth being only one.136 Other factors that could cause a stock price to drop include “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.”137 Thus, although an inflated purchase price may be a “necessary condition” to a later loss, that in and of itself does not cause the loss.138

Second, the Court found that the Ninth Circuit’s holding was unsupported by precedent.139 The Court analogized private securities fraud claims to common-law deceit and misrepresentation claims, stressing that at

125. Id. (quoting Broudo v. Dura Pharms., Inc., 339 F.3d 933, 938 (9th Cir. 2003)).
126. Id. (quoting Broudo, 339 F.3d at 938).
127. Id. at 336.
128. Id. at 342–46; see Gillespie, supra note 112, at 168–70.
129. Dura, 544 U.S. at 342–43.
130. Id. at 342.
131. Id.
132. See id.
133. Id.
134. Id.
135. Id.
136. See id. at 342–43.
137. Id. at 343.
138. Id.
139. Id.
common law “actual economic loss” is a prerequisite to recovery. Because at common law a plaintiff must show “actual damages,” the Court did not find it surprising that a number of other circuit courts rejected the inflated purchase price theory of loss. The Court, in light of other circuit rulings and the common-law bedrock of private securities actions, was unwilling to accept the “uniqueness of [the Ninth Circuit’s] perspective.”

Third, the Court found that the Ninth Circuit’s loss causation standard would not advance the overriding purposes of private securities fraud claims, nor comport with the statutory language of the PSLRA. The purpose of private shareholder fraud actions is “to maintain public confidence in the marketplace,” not to “provide investors with broad insurance against market losses.” In addition, the PSLRA “imposes on plaintiffs ‘the burden of proving’ that the defendant’s misrepresentations ‘caused the loss for which the plaintiff seeks to recover.’” The Court read the common-law foundation of Rule 10b-5 actions in conjunction with the PSLRA to require that a plaintiff prove proximate causation, a demand not met by simply alleging an inflated purchase price. The Court also made it clear that the inflated purchase price approach “would permit a plaintiff ‘with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an in terrorem increment of the settlement value, rather than a reasonably founded hope that [discovery] will reveal relevant evidence.’” Thus, to adequately plead loss causation after Dura, a plaintiff must, at a minimum, allege that a security was purchased at an inflated purchase price and that economic loss was suffered when the price dropped because of a corrective disclosure.

3. How the Dura Holding Is Prone to Multiple Interpretations

Having thoroughly rejected the Ninth Circuit’s decision, the Court then began to articulate a pleading standard to test whether a misrepresentation proximately caused an actual economic loss. The Court’s discussion of how its decision stood in light of conventional pleading standards is of critical importance to later courts’ rulings at the pleadings stage. The Court twice “concede[d]” that pleading is not intended to be overly

140. Id. at 343–44.
141. Id. at 344.
142. Id. at 345.
143. Id. at 345–46.
144. Id. at 345.
145. Id. at 345–46 (quoting 15 U.S.C. § 78u-4(b)(4) (2006)).
146. Id.
147. Id. at 347 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975)).
148. See id.
149. Id. at 346.
150. See infra Part II.
However, the Court sidestepped the question of what specific pleading standard ought to apply to loss causation under the securities laws and Rule 10b-5:

[W]e assume, at least for argument’s sake, that neither the Rules nor the securities statutes impose any special further requirement in respect to the pleading of proximate causation or economic loss. But, even so, the “short and plain statement” must provide the defendant with “fair notice of what the plaintiff’s claim is and the grounds upon which it rests.”

While the Court framed its conclusion in terms of the short and plain statement language of FRCP 8(a), the Court declined to explicitly adopt this standard. Instead, the Court showed that the plaintiffs’ complaint failed to meet the FRCP 8(a) pleading standard, even if a heightened FRCP 9(b) standard was intended by Congress. Thus, while the Dura decision clearly struck down the inflated purchase price theory in favor of a proximate cause theory, it was less than clear as to how a plaintiff must adequately plead loss causation. By discussing securities fraud claims in terms of both its common-law analog as well as the PSLRA’s language, Dura has led courts to come to differing conclusions as to the stringency to be applied to loss causation pleadings. The extent of the loss causation pleading discrepancy is investigated in Part II, where the divergent standards applied at the circuit court level are identified.

II. POST-DURA CONFUSION: THE CIRCUIT SPLIT RESULTING FROM AN UNCLEAR STANDARD

This part discusses the divergent post-Dura loss causation pleading standards applied by the Second, Fourth, Fifth, Seventh, and Ninth Circuits. The Fifth and Ninth Circuits apply a plausibility standard, requiring plaintiffs to plead that the alleged misrepresentation plausibly caused their
The Fifth Circuit applies this standard under FRCP 8(a). The Ninth Circuit also appears to consider FRCP 8(a) appropriate, although without expressly stating so. This approach contrasts with that of the Fourth and Seventh Circuits, both of which apply a more stringent standard. The Fourth Circuit requires that loss causation be pled with specificity and explicitly applies this standard under FRCP 9(b). The Seventh Circuit requires plaintiffs to plead the “very facts” that caused their loss. Although not expressly adopting a stringency standard, the Seventh Circuit appears to consider FRCP 9(b) appropriate. The Second Circuit applies a two-part loss causation test, requiring that the loss be foreseeable and that the misrepresentation be within a zone of risk concealed. This circuit refrains from specifying a pleading stringency, and instead states that loss causation is a “fact-based inquiry and the degree of difficulty in pleading will be affected by [the] circumstances.”

A. The Fifth and Ninth Circuits: Plausible Loss Causation

The Fifth Circuit’s approach to loss causation pleading is analyzed by considering the 2009 case Lormand v. US Unwired, Inc. Subsequently, the Ninth Circuit’s position is considered in the 2008 case In re Gilead Sciences Securities Litigation. The Fifth and Ninth Circuits both express their loss causation pleading standards in terms of plausibility.

1. The Fifth Circuit: Plausibility in Pleading

In Lormand, the Fifth Circuit articulated a plausibility loss causation pleading test in light of the Supreme Court decisions in Bell Atlantic Corp. v. Twombly and Dura. The court in Lormand explicitly adopted an FRCP 8(a) pleading standard.

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159. See Lormand v. US Unwired, Inc., 565 F.3d 228, 258 (5th Cir. 2009); In re Gilead Scis. Sec. Litig., 536 F.3d 1049, 1057 (9th Cir. 2008).
160. See Lormand, 565 F.3d at 258.
161. See Gilead, 536 F.3d at 1057 (“But so long as the plaintiff alleges facts to support a theory that is not facially implausible, the court’s skepticism is best reserved for later stages of the proceedings . . . .”).
162. See SEC Actions I, supra note 158 (“The fourth and seventh circuits however require that loss causation be pleaded under Rule 9(b).”).
163. See, e.g., In re Mutual Funds Inv. Litig., 566 F.3d 111, 119–20 (4th Cir. 2009); SEC Actions I.
164. Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP, 475 F.3d 824, 842 (7th Cir. 2007).
165. See id. at 843 (rejecting the plaintiffs’ contention that Dura does not require precision in pleading).
167. Id. at 174.
168. 565 F.3d 228 (5th Cir. 2009).
169. 536 F.3d 1049 (9th Cir. 2008).
170. 550 U.S. 544 (2007). Bell Atlantic Corp. v. Twombly is an antitrust case where the Supreme Court ruled that to plead infringement of section 1 of the Sherman Act, 15 U.S.C. § 1 (2006), under FRCP 8(a), a plaintiff must allege plausible facts indicating that the defendant engaged in “parallel conduct.” Twombly, 550 U.S. at 556–57. The Twombly
The plaintiffs in *Lormand* brought consolidated private class action claims and derivative shareholder claims alleging that US Unwired, Inc. violated various laws and corporate duties, including section 10(b) of the ’34 Act and Rule 10b-5.\(^{173}\) The plaintiffs alleged that, beginning in September 2000, US Unwired concealed the riskiness of various subprime customer programs it was contractually obligated to provide pursuant to a deal with Sprint Corp.\(^{174}\) Despite believing in private that the subprime strategy would be detrimental to business, US Unwired repeatedly disseminated a positive business outlook.\(^{175}\) The positive representations allegedly caused US Unwired’s stock to artificially inflate to a high of $4.94.\(^{176}\) US Unwired stock price subsequently plummeted to $0.90 per share after several public disclosures occurred between June 6, 2002, and August 13, 2002.\(^{177}\) The U.S. District Court for the Eastern District of Louisiana dismissed plaintiffs’ complaint for, among other things, failing to adequately plead loss causation.\(^{178}\)

The Fifth Circuit affirmed in part and reversed in part.\(^{179}\) In its treatment of loss causation, the court initially considered *Dura*’s effect on circuit precedent.\(^{180}\) Next, the court discussed the Supreme Court’s holding in *Twombly*.\(^{181}\) In that case, the Supreme Court dismissed the plaintiffs’ complaint, which alleged that the defendants violated antitrust laws.\(^{182}\) The *Twombly* Court held that the plaintiffs complaint lacked enough factual matter to state a claim of antitrust violations under FRCP 8(a)(2).\(^{183}\) After opinion cited *Dura* when requiring that antitrust allegations be “plausible” rather than “possible.” *Id.* at 557–58.

171. *Lormand*, 565 F.3d at 258.
172. See *id.* at 255.
173. *Id.* at 237. US Unwired, Inc. was a Louisiana corporation in the business of providing telecommunications services to customers in parts of fourteen states. *Id.* at 233.
174. *Id.* at 234, 237. US Unwired was an affiliate of Sprint Corp. providing Sprint services to over 500,000 customers. *Id.* at 233. The allegations in the plaintiffs’ complaint largely arose out of the ramifications relating to a change in US Unwired’s affiliation status. *Id.*

175. *Id.* Among other negative statements made in private, a US Unwired executive described one of the subprime programs as being a “colossal mistake.” *Id.* at 235.
176. *Id.* at 238.
177. *Id.* at 236.
178. *Id.* at 238.
179. *Id.* at 268.
180. *Id.* at 255–57.
181. *Id.* at 257–58.
183. *Id.* Specifically, the Court in *Twombly* entertained the question of whether a complaint alleging a violation of section 1 of the Sherman Act, 15 U.S.C. § 1 (2006), could survive a motion to dismiss if it lacked factual assertions of an actual agreement among the defendants to engage in anticompetitive behavior. *Id.* The Court held that the plaintiffs’ complaint made only conclusory statements that did little more than restate the grounds for a section 1 cause of action. *Id.* at 556–57. Instead, according to the Court, the plaintiffs were
discussing the holding of *Twombly*, the Fifth Circuit interpreted *Dura* and *Twombly* together to establish a loss causation plausibility test.\(^{184}\) From the outset of its loss causation inquiry, the court read *Dura* and *Twombly* as having together established FRCP 8(a) as the applicable pleading standard.\(^{185}\)

In *Greenberg v. Crossroads Systems, Inc.*\(^{186}\) the Fifth Circuit established that to plead loss causation, a plaintiff must allege that a disclosure causing an economic loss was related to a false misrepresentation and that it was “more probable than not” that the disclosure, rather than other unrelated statements, caused the loss.\(^{187}\) The *Lormand* court read *Dura* as altering its *Greenberg* standard only by requiring a disclosure to be “relevant to,” rather than “related to,” an earlier misrepresentation.\(^{188}\) Regardless, the court stated that “neither are steep or difficult standards to satisfy.”\(^{189}\) The

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\(^{184}\) *Lormand*, 565 F.3d at 257–58.

\(^{185}\) *Id.* at 255. “Though *Twombly* is an anti-trust case, it interprets Rule 8(a)(2) and how it applies generally.” *Id.* at 257 n.24. In *Twombly*’s immediate wake, however, significant debate arose concerning the extent to which *Twombly* affected the basic FRCP 8(a) pleading standard. See Kevin M. Clermont, *Litigation Realities Redux*, 84 NOTRE DAME L. REV. 1919, 1932–34 (2009) (noting that *Twombly* generated significant confusion among scholars and courts); Catherine T. Struve, *Foreword: Procedure as Palimpsest*, 422 U. PA. L. REV. 421, 422 (2010) (“*Twombly* caused urgent debate . . . .”); Amy J. Wildermuth, *What *Twombly* and Mead Have in Common*, 102 N W. U. L. REV. COLLOQUIY 276, 276 (2008), http://www.law.northwestern.edu/lawreview/colloquy/2008/12/ (“[*Twombly*] was an immediate . . . source of much academic debate.”). The debate continued after the Court decided *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009). See, e.g., Edward A. Hartnett, *Taming Twombly, Even After Iqbal*, 158 U. PA. L. REV. 473, 474 (2010) (“Naturally, critics of *Twombly* voice the same criticisms of *Iqbal* but are no longer tempered by the hope that its range might be limited.”); see also Recent Case, 123 HARV. L. REV. 580, 582–84 (2009) (discussing the plausibility pleading standard under *Twombly* and *Iqbal* and its purported expansion to all civil cases). The plaintiff in *Iqbal* sued various governmental officials for instituting a purposely discriminatory policy of targeting and arresting suspects solely because of their race, religion, or national origin in the aftermath of September 11, 2001. *Iqbal*, 129 S. Ct. at 1942–44. The Court held that the plaintiff’s allegations lacked factual support and, under *Twombly*, failed to support a plausible inference that the defendants acted with a discriminatory intent. *Id.* at 1950–53. After articulating its holding, the *Iqbal* Court stated that “[*Twombly*] expounded the pleading standard for ‘all civil actions.’” *Id.* at 1953 (quoting *Twombly*, 550 U.S. at 554). Despite this language, the plausibility standard’s ubiquitous applicability is far from certain. See Smith v. Duffey, 576 F.3d 336, 339–40 (7th Cir. 2009) (noting that the uniquely complex nature of both *Twombly* and *Iqbal* do not encourage their universal application); United States ex rel. Lusby v. Rolls-Royce Corp., 570 F.3d 849, 854–55 (7th Cir. 2009) (allowing the plaintiff’s complaint to survive a motion to dismiss although it based its claim on inferences); see also Adam Steinman, *The Pleading Problem*, 62 STAN. L. REV. (forthcoming May 2010), available at http://ssrn.com/abstract=1442786 (arguing that *Twombly* and *Iqbal* did not drastically alter conventional pleading nor necessarily conflict with decades of Court precedent). Given the already tortured and uncertain aftermath of *Iqbal*, this Note will abstain from speculating on *Iqbal*’s effect on securities pleading.

\(^{186}\) 364 F.3d 657 (5th Cir. 2004).

\(^{187}\) *Lormand*, 565 F.3d at 256 n.19 (citing *Greenberg*, 364 F.3d at 666).

\(^{188}\) *See id.* at 256.

\(^{189}\) *Id.* at 256 n.20.
court then summarized Twombly as requiring a plaintiff to plead facts sufficient to “raise a reasonable hope or expectation” that the claim will be substantiated during discovery.\(^{190}\) This standard does not require a certain probability of success, only a reasonable expectation that the elements of the claim will be substantiated.\(^{191}\) Finally, after considering its precedent, Dura, and Twombly, the Fifth Circuit concluded that, to adequately plead loss causation, FRCP 8(a) “requires the plaintiff to allege . . . a facially ‘plausible’ causal relationship between the [misrepresentations and the loss].”\(^{192}\)

2. The Ninth Circuit: Plausibility in Pleading

The Ninth Circuit explicitly left open the question of whether loss causation pleading should be evaluated pursuant to an FRCP 8(a) or 9(b) standard.\(^{193}\) However, in Gilead, the court did express its view that, as long as plaintiffs’ loss causation theory is not “facially implausible,” the suit should proceed to discovery.\(^{194}\)

In Gilead, shareholder plaintiffs brought a class action suit against Gilead Sciences, Inc. alleging violations of section 10(b) of the '34 Act and Rule 10b-5, among other claims.\(^{195}\) Gilead was a biopharmaceutical company in the business of developing and marketing drug treatments for life-threatening diseases, including HIV.\(^{196}\) Plaintiffs’ allegations centered on misrepresentations made by Gilead concerning Viread, a new HIV drug.\(^{197}\) The misrepresentations consisted of assertions that Gilead and its officers made to the public that the company was in compliance with both federal and state regulations.\(^{198}\) Specifically, Gilead asserted that it was in compliance with the FDA prohibition against marketing a drug for “off-label” use.\(^{199}\) Plaintiffs claimed that, despite these assertions, Gilead was vigorously marketing Viread for off-label use.\(^{200}\) Apparently when the FDA discovered Viread’s off-label use, it issued Gilead an “Untitled Letter” on March 14, 2002, demanding that the illegal actions cease

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190. Id. at 257.
191. Id. (citing Bell Atl. Corp. v. Twombly, 550 U.S. 544, 556 (2007)).
192. Id. at 258 (citing Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005)).
193. In re Gilead Scis. Sec. Litig., 536 F.3d 1049, 1056 (9th Cir. 2008) (“We need not resolve [the applicable FRCP] issue today.”).
194. Id. at 1057.
195. Id. at 1050.
196. Id.
197. Id.
198. Id. at 1051.
199. Id. at 1050–51. Marketing a drug for off-label use occurs when a drug is sold for the purpose of treating a condition that was not the subject of Food and Drug Administration (FDA) approval. Id. at 1051.
200. Id. at 1051. Viread had been approved by the FDA for use in about forty percent of HIV patients. Id. Plaintiffs claimed that Gilead marketed Viread for use in the other sixty percent of HIV patients, as well as for use by patients with both HIV and Hepatitis B, both of which violated FDA regulations. Id. According to the plaintiffs, as much as seventy-five to ninety-five percent of total Viread sales were for off-label uses such as these. Id.
immediately. Gilead allegedly ignored the FDA’s demand, and instead, in June 2003, informed its largest purchasers that the price of Viread would increase because of high demand, news that caused Gilead share prices to increase. The FDA then issued a “Warning Letter” on July 29, 2003, which was soon after made public, ordering Gilead to disclose its marketing of off-label use of Viread. This public disclosure did not initially affect Gilead’s share value in the market. Plaintiffs claimed, however, that the Warning Letter did cause sales to plummet in the third quarter of 2003, which eventually caused a twelve percent decline in stock price by October 28, 2003. Plaintiffs’ Rule 10b-5 claim thus asserted that Gilead continually misrepresented the true nature of Viread’s profitability, and once the FDA’s Warning Letter disclosed the illegal truth of Viread’s marketing, Viread sales plummeted, which in turn caused Gilead share prices to drop several months later after third quarter financials were released.

The U.S. District Court for the Northern District of California dismissed plaintiffs’ complaint for failing to adequately plead loss causation under Dura. Specifically, the lower court held that the plaintiffs could not connect the concealed circumstances involving off-label drug use to their loss, which occurred three months after the disclosure of the FDA Warning Letter.

The Ninth Circuit reversed. In framing its discussion, the court began by emphasizing that a court “ruling on a motion to dismiss is not sitting as a trier of fact.” The Ninth Circuit suggested that the district court was simply being incredulous, and that its unwillingness to accept plaintiffs’ allegations was premature. The Ninth Circuit went on to state that “so long as the plaintiff alleges facts to support a theory that is not facially implausible, the court’s skepticism is best reserved for later stages” of the litigation. Quoting the Supreme Court in Twombly, the Ninth Circuit explained that even if a judge thinks the chances of proving the facts alleged are “improbable, and that a recovery is very remote and unlikely,” a plaintiffs’ loss causation claim can nevertheless defeat a motion to

201. Id. An Untitled Letter is a written communication from the FDA that expresses disapproval with a firm’s promotional activity. Id. at 1052–53.
202. Id. at 1051–52. The purchasers then bought massive quantities of Viread with the legitimate intention of stockpiling the drug before the price hike. Id. Gilead’s share price jumped 13.4%. Id.
203. Id. at 1052–53. A Warning Letter is much more serious than an Untitled Letter and expresses the FDA’s opinion that a particular firm action is illegal. Id.
204. Id. at 1053.
205. Id. at 1054.
206. Id.
207. Id.
208. Id.
209. Id. at 1056–58.
210. Id. at 1057.
211. Id.; see SEC Actions I, supra note 158.
212. Gilead, 536 F.3d at 1057.
In light of *Twombly*, the Ninth Circuit decided that as long as the complaint “alleges facts that, if taken as true, plausibly establish loss causation, a Rule 12(b)(6) dismissal is inappropriate. This is not ‘a probability requirement . . . it simply calls for enough fact to raise a reasonable expectation that discovery will reveal evidence of’ loss causation.” Applying this test to the case at hand, the Ninth Circuit found issue with the district court’s ruling that three months between the alleged disclosure and economic loss was per se implausible. Despite the three month temporal gap, the drop of the “stock price was plausibly caused by the Warning Letter.” The Ninth Circuit also found that a slowing increase in physicians’ demand for Viread after the Warning Letter was made public was not too speculative.

**B. The Fourth and Seventh Circuits: Stringent Loss Causation**

The Fourth Circuit’s approach to loss causation is developed in two post-*Dura* decisions. The 2007 case *Teachers’ Retirement System of Louisiana v. Hunter* takes a stringent approach to loss causation pleading, requiring that the fraud-specific FRCP 9(b) pleading standard be met. The Fourth Circuit’s heightened pleading stance was further explained in the 2009 case *In re Mutual Funds Investment Litigation*. The Seventh Circuit’s loss causation approach is expressed in the 2007 cases *Tricontinental Industries, Ltd. v. PricewaterhouseCoopers, LLP* and *Ray v. Citigroup Global Markets, Inc.* The Seventh Circuit also supports a stringent loss causation pleading standard.

1. **The Fourth Circuit: Pleading with Specificity**

*Hunter* was a class action suit where plaintiff shareholders of Cree, Inc. filed suit against Cree, Inc. and other related defendants (together hereinafter referred to as Cree) for violations of the ’34 Act and Rule 10b-5. The complaint alleged that Cree misrepresented the nature of a number of deals with various other companies from August 12, 1999, to June 13, 2003, with the purpose of artificially inflating Cree’s stock price. Plaintiffs claimed that, to inflate the stock price, Cree became a

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213. *Id.* (quoting Bell Atl. Corp. v. Twombly, 550 U.S. 544, 556 (2007)).
214. *Id.* (quoting *Twombly*, 550 U.S. at 556).
215. *Id.* at 1057–58.
216. *Id.* at 1058.
217. *Id.*
218. 477 F.3d 162 (4th Cir. 2007).
219. *Id.* at 185–86; see SEC Actions I, supra note 158.
220. 566 F.3d 111 (4th Cir. 2009); see SEC Actions I, supra note 158.
221. 475 F.3d 824 (7th Cir. 2007).
222. 482 F.3d 991 (7th Cir. 2007).
223. *See Tricontinental*, 475 F.3d at 842.
225. *Id.* at 168–69.
party to various “channel-stuffing” schemes and “round tripping” transactions. Plaintiffs alleged that, while the various fraudulent transactions themselves were known to have existed, the true nature of the “channel-stuffing” and “round-tripping” schemes were misrepresented by Cree as having been legitimate. Plaintiffs further alleged that when the truth regarding the schemes was revealed during a lawsuit involving Cree’s current board chairman and a past CEO, Cree’s stock price dropped by almost twenty percent, causing economic loss to the shareholders.

The U.S. District Court for the Middle District of North Carolina granted Cree’s motion to dismiss because, although the plaintiffs adequately identified the defendant’s fraudulent misrepresentations, the plaintiffs failed to allege facts “supporting a strong inference of fraud” with particularity. With respect to loss causation, the district court held that plaintiffs failed to “demonstrate a direct relationship” between the alleged misrepresentation and economic loss.

The Fourth Circuit rejected plaintiffs’ appeal from the district court’s dismissal. In framing its loss causation discussion, the court recognized that loss causation is not one of the elements that the PSLRA specifically requires be plead with particularity. However, the court cited Dura in stating, “A strong case can be made that because loss causation is among the circumstances constituting fraud for which Rule 9(b) demands particularity, loss causation should be pleaded with particularity.” The Fourth Circuit interpreted the Supreme Court’s discussion of FRCP 8(a) in Dura to imply that even if FRCP 8(a) did apply, the Court would still require that “loss causation be specifically alleged and demonstrated.”

The Hunter court, in light of Dura’s concern for allowing meritless securities fraud suits past the dismissal stage, as well as Dura’s apparent

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226. Id. at 169. A “channel-stuffing” scheme is a method to artificially inflate company revenues by selling huge amounts of a product wholesale and then recording the sales as revenue. See id. Thus even though the counterparty could return the excess product at any time, revenue is recorded. See id.

227. Id. A “round-trip” transaction also artificially inflates company revenue. Id. This scheme is carried out when two parties engage in numerous needless deals to buy and sell products or services in order to increase booked revenue for both parties. Id.

228. Id.

229. See id. at 168–69.

230. Id. at 169 (quoting In re Cree, Inc. Sec. Litig., No. 1:03CV00549, 2005 WL 1847004, at *4 (M.D.N.C. Aug. 2, 2005)).

231. Id. (quoting Cree, 2005 WL 1847004, at *13).

232. Id. at 168.

233. Id. at 185 (“Loss causation is not one of the elements with respect to which the PSLRA imposes a more stringent pleading requirement. But the Act does explicitly state that a plaintiff must prove loss causation . . . .”).

234. Id. at 186 (citing Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 343–44 (2005)). The court reiterated, “Moreover, the Supreme Court has not ruled out a holding that Rule 9(b) governs a pleading of loss causation.” Id.

235. Id.

236. Id. (“A failure to recognize that loss causation be specifically alleged and demonstrated by the allegations of the complaint would ‘permit a plaintiff with a largely
requirement for more than simple FRCP 8(a) pleading. adopted a standard requiring that loss causation be plead “with sufficient specificity to enable the court to evaluate whether the necessary causal link exists.” Applying this standard to the plaintiffs’ claims against Cree, the court determined that loss causation was not pled with enough specificity because the true nature of the fraudulent transactions had either been previously disclosed, or had been entirely absent from, the internal lawsuit.

The Fourth Circuit reiterated its specificity standard in Mutual Funds. Shareholder plaintiffs filed a class action lawsuit against Janus Capital Group (JCG) and its fully owned subsidiary Janus Capital Management (JCM) (collectively, Janus) alleging violations of section 10(b) and Rule 10b-5. Janus received most of its profits through the dealings of JCM, which did business as an investment advisor and administrator of Janus mutual funds. The alleged misrepresentation centered on a clause contained in Janus prospectuses, which barred the manipulative trading practice known as “market timing.” The prospectuses not only prohibited market timing, but also threatened to temporarily or permanently shut down a violating investor’s ability to purchase shares in the fund.

Plaintiffs contended that Janus’s policy against market timing “fraudulently induced investors to buy shares in the Janus funds,” artificially inflating its price. Plaintiffs further alleged that Janus’s policy of prohibiting market timing was a deceitful misrepresentation because a complaint filed by the New York Attorney General later revealed that Janus made numerous discrete exceptions for specific investors.

groundless claim to simply take up the time of a number of other people . . . .” (quoting Dura, 544 U.S. at 347–48)).

237. Id. (“The Court required something more . . . .”).

238. Id.

239. Id. at 186–67.


241. Id. at 114.

242. Id. at 115.

243. Id. at 116. Market timing is a technique whereby sophisticated traders utilize an inherent timing delay in the valuation of funds invested in foreign securities to purchase a fund at a low price and then sell the fund at a higher price after its true value has been ascertained. See id. The timing delay occurs because some funds (like those managed by Janus) are valued once daily, typically near the closing of major U.S. markets. Id. The current true value of the foreign security investments on any given day could be observed at the closing of their respective markets. Id. Because U.S. markets close later in the day than most foreign markets, a window of time exists each day where an investor can identify the value of the foreign securities held by Janus funds and then, based on their performance, predict whether the Janus funds’ values will increase or decrease by the time of their valuations. See id. The practice of market timing produces great profits for its utilizers, but harms other investors by “diluting the value of shares, increasing transaction costs, reducing investment opportunities for the fund, and producing negative tax consequences.” Id.

244. Id. at 116–17. Janus prospectuses read, “Our stated policy is that we do not tolerate [market] timers.” Id. at 118.

245. Id. at 118.

246. See id. at 117. Internal memos allegedly showed that employees of Janus knew that what they were doing was in violation of the terms specified in the prospectus. See id.
This September 2003 disclosure allegedly resulted in a massive market correction in Janus share value, which dropped by $14 billion over the following months. 247

The U.S. District Court for the District of Maryland dismissed the complaint for failing to sufficiently plead loss causation, among other things. 248 In an opinion reversing the district court’s dismissal, the Fourth Circuit grounded its loss causation discussion in terms of proximate causation. 249 The court stated that to proximately cause a loss, a misrepresentation need not be the only cause, but must be a substantial cause of the loss. 250 After stressing that a multitude of factors can play a role in plaintiffs’ loss, the court applied the standard set forth in *Hunter* by requiring that the plaintiff plead with “sufficient specificity” how the misrepresentation was a substantial cause of their loss. 251 While recognizing that Congress did not articulate a special pleading standard for loss causation in the PSLRA, the court applied its specificity test in light of FRCP 9(b): 252

> The PSLRA’s heightened pleading requirements do not govern our analysis of the elements of . . . loss causation.

Rather, we must look to traditional pleading requirements for fraud claims. At the time of the filing of the complaint in this action, Rule 9(b) provided that “[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.” 253

The court found that the plaintiffs had pled loss causation with sufficient specificity by stating in detail that their investments in JCM were intimately connected with the performance of JCG, 254 that they suffered two specific types of losses, 255 and that the rate of share withdrawal after the disclosure increased three and a half times compared to the previous eight months. 256

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247. *Id.* at 118.
248. *Id.* at 115.
249. *Id.* at 128.
250. See *id.*
251. *Id.* at 128–29.
252. See SEC Actions I, supra note 158.
254. *Id.* at 128. Plaintiffs showed that the assets under management by Janus Capital Management (JCM) generated more than ninety percent of Janus Capital Group’s (JCG) revenue and that any significant change in JCM assets would inevitably impact JCG stockholders. *Id.* at 128–29. Plaintiffs further supported their showing of JCG’s profitability by pointing to JCG’s SEC Form 10-K. *Id.* at 129.
255. *Id.* at 128. Plaintiffs alleged two specific economic losses: one occurring when JCG was ordered to pay over $325 million in fines, penalties, and settlements to regulatory authorities, and another occurring when JCG stock plummeted by millions of dollars. *Id.*
256. *Id.* at 128–29.
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2. The Seventh Circuit: Pleading the “Very Facts”

The Seventh Circuit, although not specifically adopting FRCP 9(b),
seems to support a heightened standard of loss causation pleading.257  The
court in both Tricontinental and Ray dismissed shareholder plaintiff
complaints because they failed to plead with precision that the risk causing
economic loss was the exact risk that was concealed by the defendant’s
misrepresentation.258

In Tricontinental, Tricontinental Industries filed suit against
PricewaterhouseCoopers (PwC) for securities fraud, among other things.259
Tricontinental alleged that PwC, as an auditor, misrepresented the financial
worth of its client Anicom, Inc. to Tricontinental in connection with
transactions whereby Tricontinental acquired Anicom stock in September
1998.260

Anicom allegedly engaged in improper accounting practices to enable it
to report higher revenue than actually existed.261  Tricontinental claimed
that PwC knew of these improper practices in July 1997 but failed to
disclose this information by certifying Anicom’s 1998 and 1999 financial
statements.262  In fact, according to Tricontinental, PwC asserted that these
fraudulent financial statements were “accurate, complete and in conformity
with” Generally Accepted Accounting Principles (GAAP).263  However, in
July 2000, Anicom announced that it had conducted an internal
investigation and that it had overstated revenue by approximately $39.6
million from the first quarter of 1998 to the first quarter of 2000.264  In
January 2001, Anicom filed for bankruptcy and its stock price fell.265
Tricontinental claimed that it suffered economic loss when the price of its

257. See Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP, 475 F.3d 824, 843
(7th Cir. 2007) (rejecting plaintiffs’ contention that Dura does not require precision in
pleading).
258. See Ray v. Citigroup Global Mkts., Inc., 482 F.3d 991, 995 (7th Cir. 2007);
Tricontinental, 475 F.3d at 842.
259. Tricontinental, 475 F.3d at 827.
260. Id. at 827–28. Anicom, Inc. was a wire distribution company that had made it
common practice to acquire other corporations in exchange for Anicom stock. Id.  The
transactions at issue involved an exchange of certain Tricontinental Industries assets for
Anicom stock. Id. at 827.
261. Id. at 828. Tricontinental claimed that Anicom created fictitious sales orders, known
as “prebills,” for goods that were never purchased, thus artificially inflating its sales
recordations. Id.
262. Id. According to Tricontinental’s complaint, PricewaterhouseCoopers (PwC) had
uncovered the prebills during an investigation into Anicom’s billing practices and had
subsequently warned Anicom’s Chief Financial Officer that this practice could spread if not
addressed. Id.
263. Id.
264. Id.
265. Id. After Anicom’s bankruptcy declaration, the SEC and FBI conducted
investigations and found Anicom executives guilty of various crimes, including fraud. Id. at
828–29. The SEC’s complaints alleged that the Anicom executives lied to PwC about the
truth of their financial statements for 1998, 1999, and 2000. Id. at 829.
Anicom shares, all of which were acquired in the September 1998 purchase, fell after Anicom’s announced bankruptcy.266

The securities fraud portion of Tricontinental’s complaint alleged that PwC made deceptive and false representations in connection with Anicom’s 1997 audit statements in violation of section 10(b) and Rule 10b-5.267 The 1997 statements were the basis for Tricontinental’s business engagements with Anicom.268 The U.S. District Court for the Northern District of Illinois held that Tricontinental’s claim failed to adequately allege loss causation because Anicom’s stock dropped following the corrective disclosure of misstatements in Anicom’s post-1997 financial statements and its subsequent bankruptcy filing, but not because of public disclosure of inflated financial statements from 1997 as claimed by Tricontinental.269

The Seventh Circuit affirmed.270 The court rejected Tricontinental’s contention that Dura does not require “precision in pleading” with respect to loss causation.271 Instead, the court faulted Tricontinental for failing to set forth “any facts showing that the losses it suffered are proximately linked to the alleged misstatements in the 1997 financial statement.”272 The court relied on its prior decision in Caremark, Inc. v. Coram Healthcare Corp.273 to require that a “‘plaintiff must allege that it was the very facts about which the defendant lied which caused its injuries.’”274 Tricontinental, the court decided, had failed to show how the 2000 disclosures alluding to “accounting irregularities” directly referred to the 1997 false financial statements that Tricontinental claimed caused its loss.275 In doing so, the court rejected the possibility that the 1997 financial statement, although not the subject of the 2000 disclosures, was nevertheless part of a single ongoing fraud that could have caused plaintiffs’ loss.276

In addition to requiring the precise pleading of facts, the Seventh Circuit seemed to adopt a heightened pleading standard by framing the standard of review predominately in terms of FRCP 9(b), stressing how the PSLRA places additional requirements on pleadings as they already exist under FRCP 9(b).277 When discussing common-law fraud, the court defined the “‘circumstances constituting fraud,’” which must be stated with particularity under FRCP 9(b), as including the “‘who, what, when, where,
and how. Thus, although without explicitly saying so in the context of securities fraud, *Tricontinental* suggests that loss causation (the “how”) is to be evaluated with particularity in the Seventh Circuit.

Three months after its decision in *Tricontinental*, the Seventh Circuit again considered loss causation in *Ray*. In *Ray*, investor plaintiffs brought suit against investment advisor John Spatz, his employer, Citigroup Global Markets, Inc., and its parent company, Citigroup, Inc. (collectively, Citigroup) for section 10(b) and Rule 10b-5 violations. According to the plaintiffs’ complaint, Citigroup fraudulently induced plaintiffs to purchase exorbitant amounts of stock in Smartserv Online, Inc. (SSOL), from 2000 to 2002. Plaintiffs claimed that during this time, although the stock market as a whole had been volatile, Citigroup encouraged the purchase of SSOL stock because “SSOL was still a great deal” and SSOL had signed substantial contracts with large mainstream corporations promising huge future payoffs. However, Citigroup failed to reveal, according to plaintiffs, that SSOL was having problems fulfilling its contracts with a number of other large corporations. Plaintiffs claimed that by failing to disclose SSOL’s contractual problems and only citing its high profile signings, Citigroup caused plaintiffs to perceive SSOL as a safe investment, which induced plaintiffs’ purchase of millions of dollars of SSOL stock. Plaintiffs further contended that when the truth of SSOL’s financial position was revealed, SSOL’s share price plummeted from a high of $80 to $1 per share.

The Northern District of Illinois dismissed plaintiffs’ complaint for failing to adequately plead loss causation. The lower court found that plaintiffs could not show that the alleged misrepresentations caused SSOL’s stock price to plummet. On appeal, plaintiffs argued that “Citigroup’s misrepresentations were the reason” that the stock price fell and that “SSOL never had the contracts, revenues, or funding” that Citigroup represented.

The Seventh Circuit rejected plaintiffs’ contentions and affirmed the district court. The circuit court reiterated its requirement set forth in *Caremark* and applied in *Tricontinental* that a plaintiff must plead that “it was the very facts about which the defendant lied which caused its

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278. *Id.* at 833, 844 (quoting DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990)).
279. *See SEC Actions I, supra* note 158.
281. *Id.* at 992–93. Smartserv Online, Inc. (SSOL) was a business in the wireless data services industry. *Id.* at 993.
282. *Id.* at 993.
283. *Id.*
284. *Id.*
285. *Id.*
286. *Id.* at 994.
287. *Id.*
288. *Id.*
289. *Id.* at 992.
C. The Second Circuit: Two-Part Loss Causation

This section analyzes three cases, all decided since 2005, in which the Second Circuit discussed loss causation. The first case, Lentell v. Merrill Lynch & Co.,295 was decided three months prior to Dura. Lentell established that to proximately cause plaintiffs’ loss, the risk allegedly causing the loss must (1) have foreseeably caused plaintiffs’ loss and (2) have been within a “zone of risk concealed” by the defendant’s misrepresentation.296 The Second Circuit again considered loss causation in the January 2007 case Lattanzio v. Deloitte & Touche LLP.297 The Lattanzio court did not cite Dura, but applied the Lentell standard in finding that plaintiffs failed to plead loss causation.298 Six months after Lattanzio, the Second Circuit decided ATSI Communications, Inc. v. The Shaar Fund, Ltd.299 In ATSI, the court relied on both Dura and Lentell as it verified its previously developed proximate cause loss causation standard.300

In Lentell, class action plaintiffs were investors who allegedly relied on Merrill Lynch & Co. and key analyst Henry M. Blodget (collectively, Merrill Lynch) when deciding to invest heavily in the technology companies 24/7 Real Media, Inc. and Interliant, Inc.301 Plaintiffs’ core allegations stated that Merrill Lynch fraudulently recommended that plaintiffs purchase the technology companies’ stock over a nearly two-year period stretching from May 12, 1999, through February 20, 2001 (the class period).302 Plaintiffs claimed that Merrill Lynch rated the companies’ stock

290. Id. at 995 (quoting Caremark, Inc. v. Coram Healthcare Corp., 113 F.3d 645, 648 (7th Cir. 1997)).
291. Id.
292. Id.
293. Id. at 995–96. SSOL’s main competitors also saw their stock value deteriorate over the same time period. Id. at 993–94.
294. See supra note 290 and accompanying text.
295. 396 F.3d 161 (2d Cir. 2005).
296. Id. at 173 (emphasis omitted).
297. 476 F.3d 147 (2d Cir. 2007).
298. See infra notes 319–25 and accompanying text.
299. 493 F.3d 87 (2d Cir. 2007).
300. See infra notes 334–38 and accompanying text.
301. Lentell, 396 F.3d at 164.
302. Id. at 165.
at “buy” or “accumulate.”³⁰³ Over the class period, not because they were in fact good buys, but instead to further their banking-client relationship with the companies and increase the companies’ stock prices.³⁰⁴

Plaintiffs alleged that Merrill Lynch’s analysts did not actually believe the securities were good investments.³⁰⁵ Because of defendants’ misstatements and omissions, plaintiffs bought the companies’ stock.³⁰⁶ Finally, when the stock values deteriorated, plaintiffs lost millions of dollars.³⁰⁷ The U.S. District Court for the Southern District of New York dismissed plaintiffs’ complaint for, among other things, failing to sufficiently plead loss causation.³⁰⁸

In affirming the dismissal, the Second Circuit articulated its two-part test for loss causation in terms of proximate causation.³⁰⁹ Proximate causation in securities fraud suits, the court noted, is different than in tort suits because the defendant’s misrepresentations do not actually cause a drop in stock value.³¹⁰ It is the underlying truth concealed by the misrepresentations that causes the stock value correction.³¹¹ The court reasoned that in light of this fundamental difference, a plaintiff must allege that the subject matter of the misrepresentation caused the loss.³¹² In addition to pleading the relevant subject matter, the court required that the loss be foreseeable.³¹³ Applying this standard to plaintiffs’ claims, the court found that the alleged misrepresentations did not in fact conceal the underlying risk of the companies’ true values: risk assessing information was always available to the public and was not within the “zone of risk concealed” by the alleged misrepresentation.³¹⁴ Thus, loss causation as
applied by the Second Circuit in *Lentell* “require[s] both that the loss be foreseeable and that the loss be caused by the materialization of the concealed risk.”315

The Second Circuit reiterated its proximate cause approach in *Lattanzio*, where class action plaintiffs were shareholders of Warnaco Group, Inc. who brought suit against Warnaco’s outside accountant, Deloitte & Touche LLP.316 Plaintiffs alleged that Deloitte misrepresented Warnaco’s financial state and failed to correct previous false financial misstatements, thus concealing the risk of Warnaco’s financial collapse, and subsequently causing loss when Warnaco filed for bankruptcy.317 The Southern District of New York dismissed plaintiffs’ complaint for, among other things, failing to adequately allege loss causation.318

In affirming the district court’s dismissal, the Second Circuit applied *Lentell*’s proximate cause loss causation standard.319 The court rejected plaintiffs’ allegation that Deloitte’s misrepresentation—that its audits comported with GAAP—was the proximate cause of plaintiffs’ economic loss.320 The court held that the claimed misrepresented risk was outside the “zone of risk” acceptable under *Lentell*.321 The court noted that if simply showing that failure to meet GAAP standards was sufficient to show causation, the misrepresentation element would subsume loss causation.322 Instead, plaintiffs were required to allege that the possibility of bankruptcy was concealed, as it was the bankruptcy that caused their economic loss.323 However, the plaintiffs were unable to allege that Warnaco’s bankruptcy caused their loss because the possibility of bankruptcy was not “altogether concealed.”324 Thus, the *Lattanzio* court applied the test articulated in *Lentell*, requiring that the underlying risk concealed by defendant’s misrepresentation proximately cause plaintiff’s harm.325

The Second Circuit applied *Lentell* again in *ATSI*. ATSI Communications, Inc. was a telecommunications service provider start-up doing business in Latin America.326 ATSI sued The Shaar Fund and several related entities (hereinafter referred to as Shaar) for alleged misrepresentation and market manipulation in connection with the purchase of ATSI stock in violation of the ’34 Act and Rule 10b-5.327 Specifically, ATSI claimed that the defendant misrepresented its intention of investing in

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315. *Id.* at 173.
316. *Lattanzio* v. Deloitte & Touche LLP, 476 F.3d 147, 150 (2d Cir. 2007).
317. *Id.*
318. *Id.* at 150–51.
319. *Id.* at 157.
320. *Id.*
321. *Id.*
322. *Id.*
323. *Id.*
324. *Id.*
325. *Id.* at 157–58.
327. *Id.* at 93.
ATSI’s long-term growth by taking advantage of ATSI’s stock structure.\(^{328}\) After purchasing ATSI convertible stock, the defendants allegedly short sold massive amounts of ATSI common stock and then covered by converting their convertible preferred stock into common stock.\(^{329}\) The perpetration of this scheme allegedly created a “death spiral” and caused ATSI’s stock value to plummet.\(^{330}\) ATSI claimed that Shaar misrepresented that it would not engage in short selling of ATSI stock and that Shaar was an accredited investor as understood by Rule 501 of Regulation D under the ’33 Act.\(^{331}\) ATSI claimed that had it known the truth about Shaar’s intentions and accreditation, it never would have sold Shaar its convertible preferred stock and suffered economic loss.\(^{332}\)

The Southern District of New York dismissed three iterations of ATSI’s complaint for failing to satisfy the pleading requirements for a securities fraud claim under FRCP 9(b) and the PSLRA.\(^{333}\) The Second Circuit, after applying the heightened fraud pleading standards of FRCP 9(b) and the PSLRA to most of ATSI’s misrepresentation and market manipulation claims, ruled on loss causation for the claim alleging that Shaar fraudulently misrepresented its accreditation status.\(^{334}\)

The Second Circuit cited both Dura and Lentell for the proposition that adequate loss causation allegations require the plaintiff to show that a proximate causal link exists connecting the defendant’s misrepresentation to the alleged economic loss.\(^{335}\) The court then conducted the remainder of its inquiry under Lentell, stating that the plaintiff “must plead that the loss was foreseeable and caused by the materialization of the risk concealed by the fraudulent statement.”\(^{336}\) The plaintiffs attempted to fit their allegations

\(^{328}\) Id. at 95–96. At the time of the alleged fraud, ATSI Communications, Inc. (ATSI) was in desperate need for a capital infusion. Id. at 93. In order to raise capital, ATSI created an investor friendly stock structure whereby classes of convertible preferred stock were issued. See id. at 94. The preferred stock could be converted to common stock at favorable rates to investors after a certain date. Id. at 96.

\(^{329}\) Id. at 96. A short sell is an investing technique whereby the investor borrows a security, then sells the security with the expectation that the value of the security will fall, and then repurchases the security at a lower price in order to simultaneously repay the initial loan and come away with a profit. Id. at 96 n.1.

\(^{330}\) Id. at 96. This type of scheme allows the short seller to make extraordinary profits because the converted preferred to common stock used to cover the initial short sell was obtained at below market rates. See id. The short seller further benefits from the scheme because it is essentially risk-free: if the price of the stock unexpectedly shoots up, the convertible stocks are always available to cover without responding to market effects. See id. Finally, the scheme is detrimental to the stock issuer because each conversion and sale of preferred stock dilutes the issuer’s outstanding common stock, resulting in a decrease in its value. See id.

\(^{331}\) Id. at 95.

\(^{332}\) Id. at 106–07.

\(^{333}\) Id. at 98.

\(^{334}\) Id. at 99–106.

\(^{335}\) Id. at 106–07 (citing Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 346 (2005); Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005)).

\(^{336}\) Id. at 107 (citing Lentell, 396 F.3d at 173).
into the mold set forth by Lentell.\textsuperscript{337} They claimed that the risk concealed by defendant’s accreditation misrepresentation was their trustworthiness, which, when revealed to be poor, caused plaintiffs’ economic loss.\textsuperscript{338} However the court rejected this contention as merely a restatement of transaction causation, which explains why a transaction was made, but not why loss was caused.\textsuperscript{339} Put another way, the court found that the concealed information of Shaar’s accreditation status, when revealed, did not cause ATSI’s stock price to drop.

III. EVALUATION OF THE CURRENT CIRCUIT DOCTRINES AND WHY THE SUPREME COURT SHOULD ADOPT THE SECOND CIRCUIT’S TWO-PART LOSS CAUSATION PLEADING STANDARD

Judicial application of pleading standards is a matter of critical importance in our legal system. At this stage, one seeking justice faces the courthouse gatekeeper. The features of the court gatekeeper with respect to the loss causation element of a section 10(b) and Rule 10b-5 private securities fraud claim have received sparse treatment from Congress.\textsuperscript{340} The Supreme Court has likewise done little to define a pleading standard.\textsuperscript{341} Thus, the various circuits have been left to reconcile their contrasting loss causation pleading precedents with incomplete guidance from national lawmakers and the nation’s highest court.\textsuperscript{342}

In the absence of further input from Congress, the Supreme Court should adopt the Second Circuit’s approach to loss causation pleading. The Second Circuit’s two-part foreseeability and “zone of the risk concealed” approach is most closely in line with congressional intent, the language of \textit{Dura}, and loss causation’s historical underpinnings as a tort-developed element. Conversely, the Fourth, Fifth, Seventh, and Ninth Circuit approaches should be rejected. The Fifth and Ninth Circuits’ easily met plausibility standard fails to live up to the objectives of the PSLRA. Similarly, the Fourth and Seventh Circuits’ heightened standards are supported by neither \textit{Dura} nor the PSLRA.

A. Analysis of the Second Circuit’s Interpretation of Loss Causation and Why This Approach Should Be Adopted by the Supreme Court

The Supreme Court should adopt the Second Circuit’s loss causation pleading standard. As articulated in Part II.C, the Second Circuit evaluates loss causation at the pleadings stage pursuant to a two-part inquiry: (1) the loss must be foreseeable, and (2) the risk that caused the loss must have been within the zone of risk concealed by the misrepresentation.\textsuperscript{343} This

\begin{itemize}
  \item \textsuperscript{337} Id.
  \item \textsuperscript{338} Id.
  \item \textsuperscript{339} Id.; see supra Part I.D.1.
  \item \textsuperscript{340} See supra Part I.D.; supra notes 68–69 and accompanying text.
  \item \textsuperscript{341} See supra Part I.E.
  \item \textsuperscript{342} See supra Part II.
  \item \textsuperscript{343} See supra notes 309–13 and accompanying text.
\end{itemize}
test should be adopted rather than the plausibility standard applied by the Fifth and Ninth Circuits and the specificity standards applied by the Fourth and Seventh Circuits for three reasons.

First, and most importantly, the Second Circuit test is most in line with *Dura* and the purpose of the PSLRA. Similar to the Supreme Court, the Second Circuit has refrained from adopting a heightened FRCP 9(b) pleading standard for loss causation. However, as intended by the PSLRA, and unlike the Fifth and Ninth Circuits’ application of FRCP 8(a), the Second Circuit test does require the court to take loss causation allegations seriously at the pleadings stage.

The Second Circuit’s “zone of the risk concealed” inquiry is instrumental in satisfying the PSLRA by preventing strike suits from progressing past the pleadings stage. This inquiry determines whether the cause of loss, after such cause had been disclosed, was within the actual zone of subject matter misrepresented. Thus, if the subject matter of the alleged misrepresentation and the loss caused by a disclosure measurably differ, the allegations would fail the “zone of the risk concealed” test. This is critical. For instance, a defendant pharmaceutical firm represents that a new high profile drug will receive FDA approval, but later it is revealed that the drug will not receive FDA approval, and this disclosure is followed by a drop in existing drug sales. Under the Second Circuit’s standard, a plaintiff would not be able to claim that the representations of FDA approval caused loss when existing sales declined. The risk causing loss (existing drug sales) is not within the zone of risk concealed (likelihood of new drug approval). However, a plaintiff in the Fifth or Ninth Circuits would likely be able to construct a claim linking the new drug’s failure to gain FDA approval to the later drop in existing drug sales in a way that is not facially implausible (perhaps by alleging that the denial of FDA approval of the new drug harmed defendant’s reputation, which caused existing sales to drop). The difference between the Second Circuit approach and Fifth and Ninth Circuit approaches in this example is crucial because it is exactly this type of factual scenario that the PSLRA sought to address: where young, growing, high-tech companies experience stock volatilities because of the bang or bust nature of key products. Thus, by requiring the subject matter of the risk causing loss to factually match the corresponding misrepresentations, the Second Circuit test stays true to the primary intent of the PSLRA and protects the most vulnerable enterprises from opportunistic strike suits.

Second, Congress intended that the PSLRA codify the securities fraud pleading standards of the Second Circuit. While stopping short of

344. See supra Part II.C.
345. See supra Part II.C.
346. See supra note 312 and accompanying text.
347. See supra note 339 and accompanying text.
348. See supra note 95 and accompanying text.
349. See supra note 100 and accompanying text.
codifying Second Circuit case law, Congress suggested that courts might find this law instructive in applying the pleading requirements under the PSLRA. The two-part Second Circuit loss causation test is grounded in that circuit’s precedent, thus giving weight to the argument that Congress would look favorably upon its universal adoption.

Third, the test’s foreseeability requirement invokes loss causation’s roots in tort to ensure that if a risk is otherwise concealed and causes harm, a defendant will only be held liable for losses foreseeably caused by its actions. Such a foreseeability requirement is noticeably absent from the other circuits’ pleading standards. While foreseeability is inherently an aspect of whether a loss causation theory is tenable, the Second Circuit is unique in conspicuously subjecting any claim to a foreseeability test at the pleadings stage. In doing so, the Second Circuit uses loss causation’s tort origin as a tool to reject unmeritorious claims at the pleadings stage, although they may otherwise pass muster under a materialization of the risk test.

B. Why the Fourth, Fifth, Seventh, and Ninth Circuits’ Loss Causation Pleading Standards Should Be Rejected

The Fifth and Ninth Circuits’ plausibility approach does not do justice to the primary goal of the PSLRA: to prevent strike suits. In addition, this standard is largely derived from Twombly, a decision of uncertain relevance outside of antitrust law. The stringent standards developed by the Fourth and Seventh Circuits are equally inadequate, as neither the PSLRA nor Dura establish a heightened pleading standard for loss causation.

1. The Fifth and Ninth Circuits

In Lormand, the Fifth Circuit expressly held that FRCP 8(a) governs loss causation pleading. In its opinion, the Fifth Circuit declared that a facially plausible causal relationship between the misrepresentation and the loss is sufficient to adequately plead loss causation. In reconciling its precedent with Twombly and Dura, the court clarified that the causal relationship requires that a disclosure merely be “‘relevant to’” an earlier misrepresentation. This standard is admittedly easily met.

350. See supra note 102 and accompanying text.
351. See supra note 313.
352. See supra Part II.C.
353. See supra Part II.A–B.
354. See supra Part II.A–B.
355. See supra note 192 and accompanying text.
356. See supra note 192 and accompanying text.
357. Lormand v. US Unwired, Inc., 565 F.3d 228, 256 (5th Cir. 2009); see supra note 188 and accompanying text.
358. See supra note 189 and accompanying text.
In Gilead, the Ninth Circuit adopted a similarly facile loss causation pleading standard. Relying on Twombly and Dura, the Ninth Circuit decided that even if the plaintiffs’ theory of loss causation was unlikely to lead to recovery, a complaint should not be dismissed for this reason alone. Thus, to warrant dismissal at the pleadings stage, the Ninth Circuit must find the plaintiffs’ loss causation argument “facially implausible.”

Both the Fifth and Ninth Circuits misplace reliance on Twombly when articulating their plausibility pleading standards. In the Fifth Circuit’s pleading standard analysis in Lormand, the court initially discussed the PSLRA and the impact of Dura. However, the court then grounded much of the remainder of its discussion, and in fact framed its loss causation pleading standard in terms of, the Supreme Court’s Twombly decision. The Ninth Circuit in Gilead also adopted the Supreme Court’s language in Twombly while setting forth its loss causation standard.

However, neither Dura nor the PSLRA expressly indicated that FRCP 8(a) generally applies to loss causation. In fact, it seems clear from Dura that, in the context of securities fraud, a more stringent standard than FRCP 8(a) pleading is required. Thus, even assuming Twombly applies to pleading under FRCP 8(a) generally, which is not clearly established, it would nevertheless be inconsistent with the aims of the PSLRA in Rule 10b-5 securities fraud cases to plead under the Twombly standard. Moreover, it seems that basing a loss causation pleading standard on Twombly, given Twombly’s unclear impact on FRCP 8(a), simply increases uncertainty in the loss causation pleading context.

More importantly, the Fifth and Ninth Circuits’ pleading standards fall short of Congress’s goals in passing the PSLRA. The Ninth Circuit in Gilead stated that a complaint may proceed even if “actual proof of those facts is improbable, and that a recovery is very remote and unlikely.” This is in contravention of the purpose of the PSLRA. In fact, the core impetus for passing the PSLRA was to curtail “strike suits” that were

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359. See supra note 194 and accompanying text.
360. See supra note 210 and accompanying text.
361. See supra note 213 and accompanying text.
362. In re Gilead Scis. Sec. Litig., 536 F.3d 1049, 1057 (9th Cir. 2008); see supra note 212 and accompanying text.
363. See supra Part II.A.
364. See supra note 180 and accompanying text.
365. See supra notes 190–92 and accompanying text.
366. See supra note 213 and accompanying text.
367. See supra Part I.D–E.
368. See supra note 237 and accompanying text.
369. See supra note 185.
370. See supra Part I.D.2.
372. See supra Part I.D.2.
initiated with no hope of ultimate recovery, but simply for their settlement value.\footnote{373} The PSLRA sought to decrease such abusive suits at the pleadings stage, not after an expensive discovery process had already been permitted.\footnote{374} As applied by the Fifth and Ninth Circuits, a plaintiff presenting any plausible cause of action delays discussion of merits until after discovery.\footnote{375} Because this pleading standard is derived largely from an uncertain antitrust case, without giving adequate consideration to the concerns addressed by the PSLRA, it should be rejected.\footnote{376}

2. The Fourth and Seventh Circuits

The stringent standards applied by the Fourth and Seventh Circuits should be rejected because they do not find support in \textit{Dura} or the PSLRA. In \textit{Hunter}, the Fourth Circuit adopted a loss causation pleading standard requiring that plaintiffs plead with “sufficient specificity” the relation between a disclosure and a previous misrepresentation.\footnote{377} In doing so, the court stressed that a “strong case can be made” that loss causation should be plead with FRCP 9(b) particularity.\footnote{378} The Fourth Circuit expanded on \textit{Hunter} in \textit{Mutual Funds} and expressly applied its specificity test under FRCP 9(b).\footnote{379} Specifically, the court required a misrepresentation to proximately cause plaintiffs’ loss, which must be shown by pleading with “specificity” how the misrepresentation was a substantial cause of the loss.\footnote{380}

The Seventh Circuit, similarly to the Fourth Circuit, requires that plaintiffs specifically plead how alleged misrepresentations caused loss.\footnote{381} In \textit{Tricontinental}, the Seventh Circuit required plaintiffs to plead that the “very facts” misrepresented caused loss.\footnote{382} The court rejected plaintiffs’ contention that \textit{Dura} did not require “precision in pleading.”\footnote{383} Although not expressly requiring pleading with FRCP 9(b) particularity, the Seventh Circuit does require plaintiffs to specifically isolate the precise facts that upon disclosure caused the loss notwithstanding other contributing factors.\footnote{384}

\begin{itemize}
  \item \footnote{373} See supra notes 91–96 and accompanying text.
  \item \footnote{374} See supra note 99 and accompanying text.
  \item \footnote{375} See supra Part II.A.
  \item \footnote{376} See supra note 185 and accompanying text.
  \item \footnote{377} Teachers’ Ret. Sys. v. Hunter, 477 F.3d 162, 186 (4th Cir. 2007); see supra note 238 and accompanying text.
  \item \footnote{378} Hunter, 477 F.3d at 186; see supra note 234.
  \item \footnote{379} See supra note 253 and accompanying text.
  \item \footnote{380} In re Mut. Funds Inv. Litig., 566 F.3d 111, 128 (4th Cir. 2009); see supra note 251 and accompanying text.
  \item \footnote{381} See supra note 258 and accompanying text.
  \item \footnote{382} Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP, 475 F.3d 824, 842 (7th Cir. 2007) (quoting Caremark, Inc. v. Coram Healthcare Corp., 113 F.3d 645, 648 (7th Cir. 1997)); see supra note 274 and accompanying text.
  \item \footnote{383} Tricontinental, 475 F.3d at 843; see supra note 271.
  \item \footnote{384} See supra note 274 and accompanying text.
\end{itemize}
As articulated in Part I, the PSLRA was enacted to decrease the number of abusive lawsuits surviving the pleadings stage. Congress was clear in requiring that the elements of misrepresentation and scienter be plead with particularity. With regards to loss causation, however, Congress simply stated that a plaintiff must “prove” loss causation. By requiring pleading with specificity, the Fourth and Seventh Circuits place loss causation on equal footing with misrepresentation and scienter pleading under the PSLRA. Because Congress had a clear opportunity to articulate an identical standard for each fraud element and decided to abstain from doing so, it seems clear that these circuits have unjustifiably extended particularity in pleading to loss causation.

The more stringent standards applied by the Fourth and Seventh Circuits are not supported by Dura. Although Dura’s major shortcoming was its failure to articulate a pleading standard for loss causation, the Court did not come close to adopting FRCP 9(b). Instead, the Court framed its discussion in terms of FRCP 8(a), and, although recognizing that a plaintiff must prove loss causation, the Court nevertheless conceded that the applicable Federal Rules only require a short and plain statement. Thus, without further input from Congress, an appropriate loss causation standard must be framed as some iteration of FRCP 8(a)’s short and plain statement requirement. It follows that the question after Dura is not whether a plaintiff must submit a short and plain statement, but rather what the short and plain statement must allege.

CONCLUSION

The appropriate pleading standard to apply to the loss causation element of private securities fraud claims is a question left unanswered by Congress and the Supreme Court. The Court’s direct confrontation with loss causation in Dura Pharmaceuticals, Inc. v. Broudo established that to plead loss causation, a plaintiff must allege that an economic loss occurred after a corrective disclosure revealed the truth underlying a previous misrepresentation. However, Dura’s unanimous decision did little to delineate a test for assessing loss causation at the pleadings stage. To the contrary, the Dura Court articulated its holding through a number of assumptions and concessions, largely evading the pleadings question altogether.

Unsurprisingly, the circuit courts have interpreted Dura in a number of ways. In recent years, the courts have fashioned divergent loss causation pleading standards based on their individual readings of Dura, some

385. See supra note 95 and accompanying text.
386. See supra note 99 and accompanying text.
387. See supra notes 101–05 and accompanying text.
388. See supra note 107 and accompanying text.
389. See supra notes 100–01 and accompanying text.
390. See supra notes 151–52 and accompanying text.
applying liberal FRCP 8(a) standards, while others have advanced more stringent standards under FRCP 9(b).

The Supreme Court should not wait on Congress to revisit loss causation pleading, as the securities fraud elements have historically been judicially developed, and it has been fifteen years since lawmakers’ first and only terse treatment of the matter. The Court should instead proactively reconcile the circuit split and adopt the pleading standard currently in force in the Second Circuit. The Court should adopt the Second Circuit approach because its two-part inquiry ensures that only claims alleging a close connection between loss and misrepresentation survive pleadings, yet refrains from adopting a heightened standard unsupported by the PSLRA or Dura.