Loss Causation: A *Dura*ble Concept

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From the moment law students hear about those scales falling on Mrs. Palsgraf, the challenge of understanding and applying legal principles of causation begins. Later, as practicing attorneys, many of us experience an epiphany when we win (or lose) our first case on causation grounds. At that instant, we learn in very practical terms that even the most compelling standard-of-care expert will not save a case in which there is insufficient evidence of a causal connection between the alleged breach and the injury suffered.

Nowhere in the law have causation issues received more attention than in fraud cases, particularly securities fraud cases. However, as the U.S. Supreme Court recently demonstrated in *Dura Pharmaceuticals, Inc. v. Broudo*,[1] litigators, and even some federal circuit court judges, do not always share a common understanding of the pleading and proof requirements of causation, especially "loss causation."

Dura and other recent decisions reinforce the need to devote early and sufficient attention to the loss causation element of your next fraud case, and they offer practical suggestions for pleading and proving loss causation.

Causation 101

In fraud cases, there are generally two levels of causation analysis, each of which is known by different names. The first level of causation is causation in fact, which is often referred to as "but for" or "transaction" causation. At this level, "[t]he defendant's conduct is a cause of the event if the event would not have occurred but for that conduct; conversely, the defendant's conduct is not a cause of the event, if the event would have occurred without it."[2] In the fraud context, the *Restatement (Second) of Torts* expresses causation in fact as follows:

> The maker of a fraudulent misrepresentation is subject to liability for pecuniary loss suffered by one who justifiably relies upon the truth of the matter misrepresented, if his reliance is a substantial factor in determining the course of conduct that results in his loss.[3]

The second level of analysis is proximate causation, which is also called "legal" or "loss" causation. Frequently described as an issue of legal policy rather than a question of causation, this level of analysis becomes relevant "[o]nce it is established that the defendant's conduct has in fact been one of the causes of the plaintiff's injuries."[4] The central issue at this level is "whether the policy of the law will extend the responsibility for the conduct to the consequences which have in fact occurred."[5] In the fraud context, the *Restatement (Second) of Torts* expresses legal causation as follows:

> A fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from an action or inaction in reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance.[6]

In accompanying commentary, the *Restatement* explains the distinction between causation in fact and legal causation as follows:

> Causation, in relation to losses incurred by reason of a misrepresentation, is a matter of the recipient's reliance in fact upon the misrepresentation in taking some action or in refraining from it. (See § 546.) Not all losses that in fact result from the reliance are, however, legally caused by the representation. In general, the misrepresentation is a legal cause only of those pecuniary losses that are within the foreseeable risk of harm that it creates. . . .
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> Pecuniary losses that could not possibly be expected to result from the misrepresentation are, in general, not legally caused by it and are beyond the scope of the maker's liability. This means that the matter represented must be considered in the light of its tendency to cause those losses and the likelihood that they will follow.[7]

The *Restatement* goes on to apply this distinction to a hypothetical situation involving fraud in the purchase of stock:

> Thus one who misrepresents the financial condition of a corporation in order to sell its stock will become liable to a purchaser who relies upon the misinformation for the loss that he sustains when the facts as to the finances of the corporation become generally known and as a result the value of the shares is depreciated on the market, because that is the obviously foreseeable result of the facts misrepresented. On the other hand, there is no liability when the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial

> condition. There is, for example, no liability when the shares go down because of the sudden death of the corporation's leading officers. Although the misrepresentation has in fact caused the loss, since it had induced the purchase without which the loss would not have occurred, it is not a legal cause of the loss for which the maker is responsible.

Dura Reaffirms Loss Causation

Dura was a Rule 10b-5 securities fraud class action filed in January 1999 in federal district court in California on behalf of a putative class of investors who purchased shares in Dura Pharmaceuticals between April 15, 1997, and February 24, 1998. The investors claimed that the company inflated the price of the stock through misleading statements about its business. During the litigation, the plaintiffs alleged, among other things, that Dura misrepresented sales data for one of its antibiotic drugs, as well as the scientific success and commercial potential of a new asthma medicine for which the company was pursuing FDA approval. According to the plaintiffs, the company's stock experienced a 47 percent decline on the day following the company's disclosure of sales data for the antibiotic drug that were far lower than previous representations; the company's stock suffered an additional 40 percent decline over the following months. As pled, the designated class period coincided with the company's disclosure of the revised sales data for the antibiotic drug; however, the plaintiffs did not expressly allege that the misrepresentations concerning the asthma medication contributed to the one-day 47 percent decline, in part because the company did not make any disclosure regarding the asthma medication when the company initially revealed the poor sales of its antibiotic drug.

The district court dismissed the lawsuit with prejudice pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, as well as the heightened pleading requirements imposed by Civil Rule 9(b) and the Private Securities Litigation Reform Act (PSLRA).[8] The district court found the allegations relating to the antibiotic drug "conclusory and insufficient" and held that they would not support a finding of scienter.[9] The district court similarly found the allegations involving the asthma medication lacking. Purporting to apply the Ninth Circuit's long-standing rule that "loss causation is satisfied where 'the plaintiff shows that the misrepresentation *touches upon* the reasons for the investment's decline in value,'"[10] the district court nevertheless determined that the plaintiffs' allegations regarding the asthma medication had failed to allege a basis on which to establish loss causation.[11]

The plaintiffs appealed the dismissal to the Ninth Circuit, which reversed the district court's rulings regarding both the antibiotic drug and the asthma medication.[12] As to the former, the Ninth Circuit held that the district court should have taken "the final step of considering [the plaintiffs'] allegations collectively when conducting its scienter analysis."[13] Regarding the asthma medication claims, the Ninth Circuit stated that "loss causation is satisfied where 'the plaintiff shows that the misrepresentation touches upon the reasons for the investment's decline in value.'"[14] Acknowledging that its "touches upon" formulation of loss causation was ambiguous, but drawing on its previous fraud-on-the-market decisions, the Ninth Circuit adhered to its long-standing rule that loss causation does not always or necessarily require "a disclosure and subsequent drop in the market price of the stock . . . because the injury occurs at the time of the transaction," which is the time at which "damages are to be measured."[15] Under that standard, the Ninth Circuit held that "loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise" but merely "that the price at the time of purchase was overstated and sufficient identification of the cause."

> The Court criticized the Ninth Circuit's approach as inconsistent with the approach in the *Restatement* and among treatise writers.

The defendants appealed the Ninth Circuit's decision to the U.S. Supreme Court, which granted the defendants' petition for writ of certiorari because "the Ninth Circuit's views about loss causation differ from those of other Circuits that have considered this issue."[16] Noting that an implied private damages action under the federal securities laws "resembles, but is not identical to, common-law tort actions for deceit and misrepresentation,"[17] the Court agreed that the complaint's allegations were inadequate in respect to "economic loss" and "loss causation."[18]

Writing for a unanimous Court, Justice Breyer first rejected the logic and rationale of the Ninth Circuit's view that plaintiffs "need only 'establish,' *i.e.*, prove, that 'the price *on the date of purchase'* was inflated because of the misrepresentation," observing instead that in fraud-on-the-market cases "an inflated purchase price will not itself constitute or proximately cause the relevant economic loss."[19] He explained further:

> If the purchaser sells later after the truth makes its way into the market place, an initially inflated purchase price might mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events, which taken separately or together account for some or all of that lower price. (The same is true in respect to a claim that a share's higher price is lower than it would other-

> wise have been—a claim we do not consider here.) Other things being equal, the longer the line between purchase and sale, the more likely that this is so, i.e., the more likely that other factors caused the loss.
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> Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will sometimes play a role in bringing about a future loss. It may prove to be a necessary condition of any such loss, and in that sense one might say that the inflated purchase price suggests that the misrepresentation (using the language the Ninth Circuit used) "touches upon" a later economic loss. . . . But, even if that is so, it is insufficient. To "touch upon" a loss is not to cause a loss, and it is the latter that the law requires.[20]

The Court noted that the Ninth Circuit's rule could not be reconciled with the approach taken on loss causation by other federal circuit courts and that "the uniqueness of [the Ninth Circuit's] perspective argues against the validity of its approach in a case like this one where we consider the contours of a judicially implied cause of action with roots in the common law."[21] In the process, the Court also criticized the Ninth Circuit's approach as inconsistent with the approach in the *Restatement* and among treatise writers.

> A plaintiff who can identify and exclude certain possible factors at the pleading stage could avoid an early dismissal on loss causation grounds.

According to the Court, the Ninth Circuit's willingness to "allow recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss" did not comport with the PSLRA, which "makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss."[22] Finding that the federal rules and securities laws "must provide the defendants with fair notice of what the plaintiff's claim is and the grounds upon which it rests," the Court held that the complaint did not provide "the defendants with notice of what the relevant economic loss might be or of what the causal connection might be between that loss and the misrepresentation concerning" the asthma medication.[23] A more lenient standard 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 the [discovery] process will reveal relevant evidence,'" thus "tend[ing] to transform a private securities action into a partial downside insurance policy."[24] Finding "the plaintiffs' complaint legally insufficient, the Court reversed the Ninth Circuit and remanded the case. On remand, the plaintiffs were given an opportunity to cure the deficiencies relating to the asthma medication claims by including additional allegations relating to loss causation.

Pleading and Proving Loss Causation

Best practices for dealing with loss causation issues emerge from *Dura* and other recent decisions.

Know the applicable pleading and proof standards. It took six years and four months from the time the *Dura* plaintiffs filed their complaint for the plaintiffs to get a final ruling that their complaint did not have enough detail to survive a motion to dismiss on loss causation grounds. Such a delay can be devastating to a plaintiff's case and can result in substantial, unnecessary expense to all parties. While it is often difficult to predict how a judge or court will apply pleading or proof standards to a particular set of allegations or an evidentiary record, it is essential for the plaintiff to research thoroughly the applicable standards for pleading loss causation prior to filing the complaint. Similarly, a defendant must be conversant in loss causation jurisprudence to exploit any deficiency in loss causation allegations at the earliest tactical stage of the litigation.

Identify and analyze the tangle of factors. In *Dura*, Justice Breyer referred to the "tangle of factors" that can affect stock prices. He also noted that the likelihood of other factors causing a loss increases as the line between purchase and sale becomes longer. Similarly, Justice Kennedy observed in *Anza* that the plaintiff's "lost sales could have resulted from factors other than [the defendant's] alleged acts of fraud" and that "it would require a complex assessment to establish what portion of [the plaintiff's] lost sales were the product of [the defendant's] decreased prices."[25] Too often litigants on both sides of a case wait for deponents to be sworn and experts to opine before conducting a critical analysis of all possible factors that might have caused or contributed to an alleged loss. It is never too early, however, to compile a comprehensive list of potential causation factors and to develop a loss timeline. A plaintiff who can identify and exclude certain possible factors at the pleading stage could avoid an early dismissal on loss causation grounds. Conversely, a well-prepared defendant might build an early labyrinth of causation factors that no pleading amendment could cure. Whether seeking to exclude or include a multitude of causation factors, the parties cannot effectively design written and deposition discovery without an early analysis of all potential factors.

Watch for marketwide factors. Did industry or marketwide factors outside of the defendant's control cause or contribute to the plaintiff's losses? Ask yourself the following hypothetical: if the

defendant had done everything "correctly," would the plaintiff still have lost money? If the answer is yes, you likely have a difficult loss causation case on your hands. Generally, where there is evidence that plaintiff's losses were caused by a "marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the defendant's fraud decreases."[26]

For example, in *Movitz v. First National Bank of Chicago*, the Seventh Circuit took a hard line on the issue of loss causation, requiring the plaintiff to show that the defendant caused the plaintiff's losses, to the exclusion of other potential causes. The plaintiff sought the help of the defendant bank to buy commercial real estate in Houston, Texas. The bank, however, failed to investigate the property and ensure that the structure was sound and that the heating and air conditioning were functional—a serious problem in Houston's climate. The plaintiff claimed that as a result of the bank's failure, it lacked sufficient tenants, the mortgagor foreclosed, and the plaintiff lost his entire investment. At trial, the jury found the defendant's conduct caused the plaintiff's losses and caused the plaintiff $3.3 million in damages.

The Seventh Circuit, however, overturned the jury's award. Although there was enough evidence to show that, "but for" defendant's conduct, the plaintiff may not have purchased the building and would not have lost his money, the plaintiff failed to prove that the defendant's actions ultimately caused plaintiff's losses. The Seventh Circuit noted that, just after plaintiff bought the building, the Houston commercial real estate market crashed. The loss was due almost entirely to the crash in the real estate market. Accordingly, even if the defendant had acted properly in failing to research the building's structural soundness or if the plaintiff had sought an alternative commercial real estate investment, the plaintiff would still have lost money because the market crash that ultimately wiped out the plaintiff's investment was citywide.[27]

Are you in "the zone"? Many courts have used traditional proximate cause terminology such as "zone of interests" and "foreseeability" when analyzing loss causation issues. Before the court poses the question to you at the podium, ask yourself whether the loss was a reasonably foreseeable result of the defendant's conduct or, stated differently, whether the risk that caused the loss was within the zone of risk concealed by the defendant's misrepresentation, omission, or negligent conduct. If the loss was not reasonably foreseeable or within a reasonable zone of interests, you will have difficulty establishing loss causation.

For example, the Seventh Circuit held in *Movitz* that the defendant could not have foreseen the loss that materialized from the marketwide decline. According to the court, the defendant could not have known that the Houston commercial real estate market was going to crash, and more importantly, there was no evidence of "what the building would have been worth . . . when [plaintiff] was wiped out by the foreclosure, had the bank exercised due care."[28]

What risks did the plaintiff assume? If you represent the plaintiff, ask yourself whether your client assumed the investment risk, that is, was she aware that the potential investment was risky and therefore volatile. If you believe she did not, be prepared to present evidence that the investment risks were concealed and that those concealments caused the plaintiff's losses. For example, the plaintiffs in *Lentell* alleged that "'the risks that materialized [from purchasing the stock] were risks of which they were unaware as a result of Defendants' scheme to defraud,' and that they would not have been injured absent the scheme."[29] On that issue, the court found that, prior to investing in the defendants' stock, the plaintiffs received research reports "full of unchallenged analysis suggesting that the [defendant companies] were volatile investments, and therefore subject to sudden and substantial devaluation risk."[30] According to the court, the indicia of investment risk were "unambiguously apparent on the disclosures alleged to conceal the very same risk."[31] The court concluded that to prove successfully that defendant's fraud caused their losses, "plaintiffs were required to allege facts to establish that the [defendant's] misstatements and omissions concealed the price-volatility risk (or some other risk) that materialized and played some part in diminishing the market value of [defendant stock]," or "facts sufficient to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed an investment."[32] Because the plaintiffs did neither, the court found no factual basis to support their allegations of fraud.

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Find the right expert at the right time. There are many factors affecting the use and timing of expert testimony. In the appropriate case, an expert can be very helpful in analyzing loss causation issues, developing a strategy for making or challenging loss causation allegations, crafting a discovery plan to elicit necessary evidence and presenting effective testimony at trial. In *Movitz*, for example, the court found that plaintiff could have recovered at least some of the loss but failed to put on sufficient and particularized evidence to support a claim for any damages. The court explained that the plaintiff could have put on a witness, most likely an expert, "who would value the property on the date of purchase on the assumption that the net income had been correctly calculated and the structural defects repaired."[33] Assuming the plaintiff could have purchased the building for less money had the "bank done its job," the damages in the lawsuit could have been

the difference between the loss that the plaintiff would have sustained had the bank acted with due care, and the larger loss that it actually sustained.[34] Because the plaintiff did not take this approach to calculating damages and "separate the losses due to [the defendant's] errors from the errors due to the collapse of the commercial real estate market," the plaintiff recovered nothing.[35]

Conclusion

Pleading and proving loss causation requires a careful and thoughtful analysis. Waiting to conduct that analysis until after you have filed your complaint or until after discovery has carved the outlines of your case could prove costly. Unlike the plaintiffs in *Dura*, it should not take you six years to figure out that you needed to allege additional facts to establish the causal link between your client's losses and the defendant's conduct. Start today. You will be glad you did. ■

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Endnotes

1. Dura Pharm., Inc. v. Broudo, 125 S. Ct. 1627 (2005).
2. PROSSER & KEETON, THE LAW OF TORTS, § 41 at p. 266 (5th ed. 1984). Considered a "rule of exclusion," the concept of "but for" causation "serves to explain the greater number of cases," but it does not resolve, for example, the situation in which two or more causes "concur to bring about an event, and either one of them, operating alone, would have been sufficient to cause the identical result." *Id.* In the latter context, courts have adopted the "substantial factor" analysis to determine which of two or more causes was the "cause in fact" of the event.
3. RESTATEMENT (SECOND) OF TORTS, § 546.
4. PROSSER & KEETON, § 42, at pp. 272–73; *id.*, § 41, at p. 264 (proximate cause reflects "ideas of what justice demands, or of what is administratively possible and convenient").
5. PROSSER & KEETON, § 41, 42; *see also id.*, § 110, at 767 (losses do "not afford any basis for recovery" if "brought about by business conditions or other factors"); Holmes v. Sec. Investor Prot. Corp., 503 U.S. 258, 268 (1992) (using the term, proximate cause, "to label generically the judicial tools used to limit a person's responsibility for the consequences of that person's own acts"; reference to common law "demand for some direct relation between the injury asserted and the injurious conduct alleged"); *id.* at 287 (Scalia, J., concurring) ("[I]t has always been the practice of common-law courts (and probably of all courts, under all legal systems) to require as a condition of recovery, unless the legislature specifically prescribes otherwise, that the injury have been proximately caused by the offending conduct. . . . Judicial inference of a zone-of-interests requirement, like judicial inference of a proximate cause requirement, is a back-ground practice against which Congress legislates.").
6. RESTATEMENT (SECOND) OF TORTS, § 548A.
7. RESTATEMENT (SECOND) OF TORTS, § 548A, comments a and b.
8. *In re* Dura Pharm., Inc. Sec. Litig., Case No. 99cv0151-L(NLS), 2001 U.S. Dist. LEXIS 25907 (S.D. Ca. Nov. 2, 2001); 15 U.S.C. § 78u-4(b)(2).
9. *In re* Dura Pharm., 2001 U.S. Dist. LEXIS 25907, at *38–43.
10. *Id.* at *30–31 (emphasis added); *see also id.* ("[a]t the pleadings stage, plaintiffs do not need to meet a strict test of direct causation [but rather just] 'some causal nexus' between the defendants' misconduct and the plaintiffs' losses").
11. *Id.* at *31–32.
12. Broudo v. Dura Pharm., Inc., 339 F.3d 933 (9th Cir. 2003).
13. *Id.* at 940.
14. *Id.* (quoting Binder v. Gillespie, 184 F.3d 1059 (9th Cir. 1999)).
15. *Id.*
16. Dura Pharm., Inc. v. Broudo, 125 S. Ct. 1627, 1630 (2005).
17. *Id.* at 1631, 1632 ("Judicially implied private securities-fraud actions resemble in many (but not all) respects common law deceit and misrepresentation actions.") (citations omitted).
18. *Id.* at 1631. The Court noted that "the common law has long insisted that a plaintiff in [an action for fraudulent misrepresentation] show not only that had he known the truth he would not have acted but also that he suffered actual economic loss." *See also* Associated Gen. Contractors of Cal., Inc. v. Cal. State Council of Carpenters, 459 U.S. 519, 533–34, (1983) (discussing federal courts' interpretation of many federal statutes as "incorporate[ing] common-law principles of proximate causation" and holding that section 4 of the Clayton Act required a plaintiff to show "not only that the defendant's violation was a "but for' cause of his injury but was the proximate cause as well"); Holmes v. Sec. Investor Prot. Corp., 503 U.S. 258 (1992) (upholding trial court's entry of summary judgment in favor of defendant because of plaintiff's failure to satisfy proximate cause element of Civil RICO claim); Anza v. Ideal Steel Supply Corp., 126 S. Ct. 1991, 2006 U.S. LEXIS 4510 (2006) (upholding trial court's dismissal of Civil RICO claim; plaintiff failed to prove proximate causation under principles set forth in *Holmes*).
19. *Dura*, 125 S. Ct. at 1631.
20. *Id.*; *see also Holmes*, 503 U.S. at 543–45 (citing *Associated Gen. Contractors*, and noting that "the less direct an injury is, the more difficult it becomes to ascertain the amount of a plaintiff's damages attributable to the violation, as distinct from other, independent factors"); *id.* (noting that its "use of the term 'direct' should merely be understood as a reference to the proximate-cause inquiry that is informed by the concerns set out in the text [of its opinion]"); *Anza*, 2006 U.S. LEXIS 4510, at *17 (concerns expressed in *Holmes* "illustrate why Ideal's alleged injury was not the direct result of a RICO violation").
21. *Dura*, 125 S. Ct. at 1633.
22. *Id.*
23. *Id.* at 1634 (citation omitted).
24. *Id.* (citation omitted).
25. *Anza*, 2006 U.S. LEXIS 4510 at *16–17 (Kennedy, J.) (noting that "[b]usinesses lose and gain customers for many reasons").
26. Lentell v. Merrill Lynch & Co., 396 F.3d 161, 174 (2d Cir. 2005). In *Lentell*, the plaintiffs had alleged that defendant issued false and misleading reports making certain investment recommendations were falsely optimistic and made only "to cultivate the Firm's investment banking clients." *Id.* at 164. When the plaintiffs lost money on their investment, and, after the defendant's alleged misrepresentations were revealed, plaintiffs sued. The district court dis-

missed the plaintiffs' complaint for several reasons including failure to plead loss causation. The Second Circuit affirmed the district court, holding that the plaintiff's complaint "failed to plead that the alleged misrepresentations and omissions caused the claimed losses." *Id.* Specifically, the court concluded that to "plead loss causation, the complaints must allege facts that support an inference that Merrill's misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud." *Id.* at 175. Indeed, the court found that "there was no allegation that the market reacted negatively to a corrective disclosure regarding the falsity of Merrill's . . . recommendations and no allegation that Merrill misstated or omitted risks that did lead to the loss." *Id.* Without this proof, plaintiff's claim was fatally deficient.

27. Movitz v. First Nat'l Bank of Chi., 148 F.3d 760, 764 (7th Cir. 1998).

28. *Id.* at 765.

29. *Lentell,* 396 F.3d at 176.

30. *Id.*

31. *Id.* at 177.

32. *Id.*

33. *Movitz*, 148 F.3d at 765.

34. *Id.*

35. *Id.*