LOSS CAUSATION DECODED

MEIRING DE VILLIERS[*]

ABSTRACT

In the landmark case of Dura Pharmaceuticals, Inc. v. Broudo,[1] the U.S. Supreme Court counseled lower courts to interpret the loss causation element of Rule 10b-5 in accordance with common law tort principles of causation. The Court did not, however, specify how the principles apply in securities class actions. The minimalist instruction has led lower courts to issue "confusing and inconsistent decisions that incorporate little of the reasoning upon which the common law principles are based. . . . [resulting in] a series of decisions that are . . . unfaithful to the common law."[2] This Article shows that the loss causation doctrine is more coherent than courts have indicated. It develops an interpretation of loss causation as a translation of the common law tort doctrines of factual and proximate cause into a fraud-on-the-market context that is faithful to their traditional common law meaning. The interpretation identifies the relations between the defendant's fraud, a corrective disclosure, and the plaintiff's economic loss that must be pleaded and proven to establish loss causation. It facilitates loss causation analysis, especially in cases with complex fact patterns, and sheds new light on aspects of Rule 10b-5 litigation, including causation and damages.

"[T]he meaning of loss causation remains a source of much misunderstanding . . . [and] has not always been expressed with great precision and clarity."[3]

INTRODUCTION

In a classic securities fraud class action, Rule 10b-5 cognizable fraud—such as a material misstatement or omission—artificially inflates the market price at which an investor purchases a security.[4] A corrective disclosure eventually signals the truth to the market, directly or indirectly,[5] and the

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[*] Consulting Director, LECA Consulting, Ltd., meiring.devilliers@gmail.com.

[1] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 346 (2005).

[2] Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 871 (2009) (emphasis added).

[3] Loreley Financing No. 3 v. Wells Fargo Sec., 797 F.3d 160, 183 (2d Cir. 2015).

[4] Jon Koslow, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 FORDHAM L. REV. 811, 820 n.40 (1991), the author explains the impact of misrepresentations:

> A misrepresentation can also cause a stock to be artificially deflated, as in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), which involved false information about a mineral ore discovery. The analysis is similar. For the sake of simplicity, the examples used throughout this Article involve misinformation that artificially inflates the stock price.

[5] FindWhat Inv. Grp. v. FindWhat.com, 658 F.3d 1282, 1311 n.28 ("A corrective disclosure can come from any source, and can 'take any form from which the market can absorb [the information] and react

investor suffers a loss when the share price declines.[6] To prevail on a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934[7] and Rule 10b-5 of the Securities and Exchange Commission,[8] the most widely used antifraud provisions in federal securities law,[9] the plaintiff must prove "loss causation,"[10] which is broadly defined as a causal connection between the defendant's fraud and the plaintiff's economic loss.[11]

The PSLRA codified the loss causation requirement by adding Section 21(D)(b)(4) to the Securities Exchange Act of 1934.[12] This provision, entitled "Loss Causation," provides that plaintiffs in private fraud actions "shall have the burden of proving that the act or omission of the defendant . . . caused the loss for which the plaintiff seeks to recover damages."[13] The circuit courts were initially divided in their interpretation of the statutory requirement.[14] Under the majority view, loss causation requires proof of a causal link between the defendant's fraud and actual economic

. . . .' " (quoting 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, 64–71 (2008))).

[6] *See, e.g.*, Fisch, *supra* note 2, at 843 ("Consider . . . the typical securities fraud plaintiff who purchases securities at a time when the defendant's falsely positive statements or concealment of negative information has inflated the market price. The plaintiff pays a price that is higher than he or she would have paid if the market knew the truth. At a subsequent point in time, the fraud is revealed—either directly through a corrective disclosure or indirectly through the occurrence of events that are inconsistent with the original lies. The stock price declines."); Jay W. Eisenhofer, Geoffrey C. Jarvis & James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 BUS. L. 1419, 1419–20 (2004) (describing the scenario in which an inflated stock price declines in response to a corrective disclosure, as a "classic securities fraud case").

[7] 15 U.S.C. § 78j(b).

[8] 17 C.F.R. § 240.10b-5 (2023).

[9] *See, e.g.*, Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 540 (2011) ("[Rule 10b-5] can make a plausible claim to being the most consequential piece of American administrative law."); Evan Hill, *The Rule 10b-5 Suit: Loss Causation Pleading Standards in Private Securities Fraud Claims After Dura Pharmaceuticals, Inc. v. Broudo*, 78 FORDHAM L. REV. 2659, 2666 (2010) ("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 l0b-5.").

[10] 15 U.S.C. § 78u-4(b)(4) (providing that plaintiffs in private fraud actions "shall have the burden of proving that the act or omission of the defendant . . . caused the loss for which the plaintiff seeks to recover damages.").

[11] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–2 (2005) ("In cases involving publicly traded securities and purchases or sales in public securities markets, the action's basic elements include: . . . 'loss causation,' i.e., a causal connection between the material misrepresentation and the loss.") (citing 15 U.S.C. § 78u– 4(b)(4)).

[12] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, §§ 21D(b)(4), 109 Stat. 737, 747 (codified at 15 U.S.C. § 78u-4(b)(4) (2006)).

[13] 15 U.S.C. § 78u-4(b)(4).

[14] Hill, *supra* note 9, at 2673–74, explaining how the circuit courts adjusted to the *Dura* ruling:

> 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 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.

(footnotes omitted).

loss to the plaintiff.[15] In contrast, a minority held that plaintiffs need only show that the purchase price was inflated because of the misrepresentation.[16]

In the landmark case of *Dura Pharmaceuticals, Inc. v. Broudo*,[17] the United States Supreme Court resolved the conflict among the circuit courts. In a unanimous decision, the Court held that merely alleging price inflation at the time of purchase does not establish loss causation in a fraud-on-the-market case.[18] Rather, a plaintiff must demonstrate loss causation by pleading and proving a causal connection between the challenged conduct and the investment's subsequent decline in price.[19]

Dura was a seminal decision, but it is a "minimalist text" that resolved a single issue narrowly[20] and left many questions unanswered.[21] The decision counseled lower courts to interpret loss causation in accordance with common law tort principles,[22] but did not specify how the principles

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[15] *See, e.g.*, Semerenko v. Cendant Corp., 223 F.3d 165, 184–85 (3d Cir. 2000) (holding that loss causation is established only if the value of the security "actually decline[s] as a result of [the] alleged misrepresentation."); Emergent Cap. Inv. Mgmt. v. Stonepath Grp., Inc., 343 F.3d 189, 198–99 (2d Cir. 2003) (holding that alleging an inflated purchase price is insufficient to satisfy loss causation pleading requirement); Bastian v. Petren Res. Corp., 892 F.2d 680, 684–86 (7th Cir. 1990), *cert. denied* 496 U.S. 906 (1990) (holding that alleging an inflated purchase price is insufficient to satisfy loss causation pleading requirement).

[16] *See, e.g.*, Broudo v. Dura Pharms., Inc., 339 F.3d 933, 938 (9th Cir. 2003) ("[I]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price *on the date of purchase* was inflated because of the misrepresentation." (quoting Knapp v. Earnst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996))).

[17] *Dura*, 544 U.S. at 338.

[18] *Id.* at 346.

[19] *Id.* at 342; *see also* Merritt B. Fox & Joshua Mitts, *Event-Driven Suits and the Rethinking of Securities Litigation* 78 BUS. L. 11 n.22 (2022) ("A showing of loss causation requires not only that the misstatement inflated the issuer's share price, but also that there was a causal connection between this inflation and a loss by the plaintiff." (citing *Dura*, 544 U.S. at 346–48)).

[20] *See, e.g.*, John C. Coffee, Jr., *Loss Causation After* Dura*: Something for Everyone,* 231 N.Y. L.J. 2, 2 (2005) ("[*Dura*] is a minimalist text, which holds only that payment of an inflated purchase price, without more, does not by itself constitute an actionable economic loss."); *In re* CIGNA Corp. Sec. Litig., 459 F. Supp. 2d 338, 349 (E.D. Pa. 2006) ("*Dura Pharmaceuticals* only rejected the Ninth Circuit's position that, for pleading purposes, a plaintiff need only establish that 'the price *on the date of the purchase* was inflated because of the misrepresentation.' " (quoting *Dura*, 544 U.S. at 342)); Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 360 (2007) ("[T]he [*Dura*] Court's decision settled only one issue: a plaintiff who alleges and establishes that the defendant has made a materially false statement does not sufficiently establish loss causation without connecting the loss to the misrepresentation.").

[21] *See, e.g.*, Merritt B. Fox, *After Dura: Causation in Fraud-on-the-Market Actions*, 31 J. CORP. L. 829, 846–47, 865–74 (2006) (discussing "questions left open by the Court's decision in *Dura*"); Burch, *supra* note 20, at 350–51 (describing *Dura* as missed opportunity in which Court "muddied the water with regard to what constituted loss"); Fisch, *supra* note 2, at 815 ("Notwithstanding [the attention of the Supreme Court in *Dura* and *Stoneridge*], the parameters of the causation requirement remain unclear."); Madge S. Thorsen, Richard A. Kaplan & Scott Hakala, *Rediscovering the Economics of Loss Causation*, 6 J. BUS. & SEC. L. 93, 116 (2006), explaining the problem created by the Court's decision:

> Enter *Dura.* Styled as a pleading case, commentators and parties have, nonetheless, hoped that *Dura* would afford the court an opportunity to clarify loss causation concepts in securities fraud litigation. For the most part, the Court declined the invitation, leaving the doctrinal development to the lower courts and leaving the direction of that development wide open.

[22] *See, e.g.*, Fisch, *supra* note 2, at 811, explaining the impact of the *Dura* decision on lower courts:

> The Dura decision itself said little[] but counseled lower courts to fashion new requirements of causation and harm modeled upon common law tort principles. These instructions have led lower courts to craft a series of confusing and inconsistent decisions that incorporate little of the reasoning upon which the common law principles are based.

Allen Ferrell, *Corporations, Securities and Antitrust The Supreme Court's 2005-2008 Securities Trio: Dura Pharmaceuticals, Tellabs and Stoneridge*, 9 ENGAGE 32, 33 (2008) ("[T]he [*Dura*] Court emphasized the common law tort origins of the 'loss causation' requirement.").

apply in a securities fraud context.[23] It did not, for instance, specify what level of particularity would be adequate at the pleading stage,[24] what kind of evidence would suffice to prove loss causation at trial,[25] and how to deal with complex issues, such as intervening and superseding cause.[26] The result has been "confusing and inconsistent decisions that incorporate little of the reasoning upon which the common law [tort] principles are based."[27] In a powerful critique of lower courts' adjudication of loss causation post-*Dura*, Professor Jill Fisch concludes,

[23] *See, e.g.*, William F. Sullivan, Christopher H. McGrath, Joshua G. Hamilton, John J. O'Kane IV & Adam M. Sevell, *Pleading and Proving Loss Causation: Litigating Securities Fraud in a Post-*Dura *World*, 4 BL. REP. 1, 2 (2010) ("[D]ifferent circuits continue to grapple with the appropriate interpretation of the loss causation pleading standard set forth in *Dura* . . . *Dura* formulated the rule on pleading and proving loss causation, but the contours of the rule continue to be shaped."); Andrew J. Morris & Lucius Outlaw, *Clarifying Loss Causation: Reconciling the 'Zone of Risk' Test With Dura Pharmaceuticals*, 38 SEC. REG. & L. REP. (BL) 35, 35 (2006) ("[*Dura*] requires that securities fraud plaintiffs identify a disclosure of the 'relevant truth' and a resulting decline in stock price. The *Dura* Court did not, however, explain exactly what truth must come out at the time of the plaintiffs' loss in order to satisfy this requirement.") (footnote omitted).

[24] *See, e.g.*, Dennise Martinez, *Loos v. Immersion Corporation: Redefining the Standard in Loss Causation Arguments*, 6 CAL. L. REV. 18, 20 (2015) ("Although the *Dura* Court required plaintiffs to link their financial loss to a misrepresentation, it did not precisely identify *how* loss causation must be pled. Accordingly, the decision has confused lower courts seeking to define the particular contours of what constitutes a corrective disclosure."); Sullivan et al., *supra* note 23, at 1 ("The Supreme Court in *Dura* stopped short . . . of identifying the extent to which plaintiffs must allege facts demonstrating loss causation to survive a motion to dismiss.").

[25] *See, e.g.*, Fox, *supra* note 21, at 847, the author notes:

> [A] large open question concerns what, for purposes of pleading, would, beyond the allegation that the misstatement inflated the purchase price, constitute a sufficient 'indication of the loss and the causal connection' and what, for purposes of proof at trial, would constitute the kind of evidence sufficient to establish that there had been an inflation in price that proximately caused an economic loss.

Matthew L. Mustokoff & Margaret E. Mazzeo, *Loss Causation on Trial in Rule 10b-5 Litigation a Decade after* Dura, 70 RUTGERS U. L. REV. 175, 177 (2017) ("[W]hat *Dura*—a *pleading* case—meant for purposes of *proving* loss causation and damages at trial was anyone's guess."); Thorsen et al., *supra* note 21, at 116; Sullivan et al., *supra* note 23 ("*Dura* has also made surviving summary judgment more difficult for plaintiffs in securities fraud cases. That does not, however, mean that courts have adopted a uniform approach regarding the precise evidentiary showing required to establish loss causation."); Bryan L. Phipps, In re *Williams Securities Litigation—WCG Subclass: How Dura Met Daubert*, 2010 BYU L. REV. 215, 222 (2010) ("W]hile *Dura* explained what form of pleading was inadequate, it did not go so far as to say what level of detail would be sufficient to show loss causation.").

[26] *See, e.g.*, Fisch, *supra* note 2, at 840–41 ("The courts' application of tort law causation principles, particularly complex causation principles, to securities fraud has been highly imperfect . . . . The distortion of common law principles is perhaps most evident in several recent securities cases applying the concepts of superseding and intervening cause."); David S. Escoffery, *A Winning Approach to Loss Causation under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 FORDHAM L. REV. 1781, 1781 (2000) (citing THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 704 (Hornbook Series, Student Edition 2d ed. 1990) ("While circuits agree that loss causation refers to the causal nexus between a plaintiff's injury and a defendant's wrongful conduct, they disagree on how direct the connection must be.")).

[27] Fisch, *supra* note 2 at 811; *see In re* Wash. Pub. Power Supply Sys. Sec. Lit., 650 F. Supp. 1346, 1352 (W.D. Wash. 1986) ("It is apparent from the inconsistencies in the case law that there is some confusion as to the meaning of loss causation."); *see also id.* at 871, describing the complexities of causation analysis:

> Causation analysis has become one of the most complicated aspects of private federal securities fraud litigation. The courts have struggled to fashion a causation requirement, demonstrating relatively little understanding of the goals of the causation inquiry and of the nature of the harm to which the inquiry should be addressed. Although the Supreme Court determined that lower courts should use tort law principles in formulating an approach to causation, to date, the lower courts have failed in their efforts to do so. The result is a series of decisions that are inconsistent, unfaithful to the common law, and largely incoherent.

> [d]espite the claim that causation in securities fraud is modeled on common law tort principles, the lower courts have not been faithful to this claim and have either ignored or misapplied important common law guidance on the meaning of proximate cause, the role of intervening cause, and the legal effect of multiple or indeterminate causation.[28]

The Second Circuit, in *Loreley Financing No. 3 v. Wells Fargo Securities*,[29] echoed Fisch's opinion, lamenting that "the meaning of loss causation remains a source of much misunderstanding," and "has not always been expressed with great precision and clarity."[30]

The Article shows that the loss causation doctrine is more coherent than courts have indicated. It develops an interpretation of loss causation as a translation of the tort doctrines of factual and proximate cause that preserves their core policy goals in a fraud-on-the-market context. The interpretation facilitates loss causation analysis, especially in cases with complex fact patterns, and sheds new light on aspects of Rule 10b-5 litigation, including causation and damages.

The remainder of this introductory Section summarizes the analytical core of the Article, namely (1) analysis of the traditional tort doctrines of causation and their "meaning"; (2) interpretation of loss causation as a translation that preserves the meaning; (3) analysis of the interpretation and its application in securities fraud litigation, including Rule 10b-5 damages.

The tort doctrine of causation has two distinct components: factual (or but-for) cause and proximate cause.[31] To impose liability, the challenged conduct must be both the proximate and factual cause of the plaintiff's harm.[32] Lower courts adjudicating fraud-on-the-market cases have interpreted loss causation accordingly, namely, as an umbrella term encompassing factual and proximate cause.[33] In *FindWhat Investor Group v. FindWhat.com*,[34] the Eleventh Circuit, quoting the Supreme Court in *Dura*,[35] other circuit opinions,[36] and a leading securities law treatise,[37] stated that

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[28] Fisch, *supra* note 2, at 860.

[29] Loreley Fin. (Jersey) No. 3 v. Wells Fargo Sec., 797 F.3d 160 (2d Cir. 2015).

[30] *Id.* at 183.

[31] *See, e.g.*, JOHN C.P. GOLDBERG & BENJAMIN C. ZIPURSKY, THE OXFORD INTRODUCTIONS TO U.S. LAW: TORTS 94 (2010) ("The causation element has two distinct components. One is known as *actual cause*' (or 'cause-in-fact'). The other is '*proximate cause*' (or 'legal course' or 'scope of liability').").

[32] *Id.* at 98 ("The proximate cause requirement is, of course, expressed by the qualification that the defendant's carelessness must not only have been an actual cause of the plaintiff 's injury, but also a proximate cause.")

[33] *See, e.g.*, Fisch, *supra* note 2, at 840 ("[t]he courts have modeled the causation requirement in securities fraud on the traditional concepts of but-for and proximate cause; indeed, the courts freely employ these terms, citing to common law authorities such as the Second Restatement.")

[34] 658 F.3d 1282 (11th Cir. 2011).

[35] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 344–46 (2005), noting:

> [T]he common-law roots of the securities fraud action" and holding that the loss causation element ensures that the securities laws "protect [investors] against [only] those economic losses that misrepresentations actually cause" [and] "that a plaintiff [must] prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss.

[36] *See, e.g.*, *In re* Omnicom Grp., Inc. Sec. Litig., 597 F.3d 501, 510 (2d Cir. 2010).

[37] THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 12.11 (6th ed. 2009) (section cited with approval in *Dura*, 544 U.S. at 342) ("Causation in securities law involves the same analysis of cause in fact and legal cause that was developed under the common law.").

"[t]he loss causation element of a Rule 10b-5 claim requires that the defendant's fraud be both the but-for and proximate cause of the plaintiff's later losses."[38]

The most widely used test of factual causation is the but-for test, which states that an act is the factual cause of an injury if but-for the act, the injury would not have occurred.[39] Factual cause is uncontroversial in securities fraud litigation.[40] To establish liability, the fraud-on-the-market plaintiff must show that a foreseeable corrective disclosure *factually caused* the stock price decline on which the plaintiff's loss causation and damages theories are predicated.[41]

Factual cause is typically proven by performing an event study.[42] An event study is a statistical technique that determines whether an event, such as a merger announcement or product recall, is associated with a statistically

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[38] *FindWhat*, 658 F.3d 1282, 1309 (11th Cir. 2011).

[39] RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL & EMOTIONAL HARM § 26 (AM. L. INST. 2010) ("Conduct is a factual cause of harm when the harm would not have occurred absent the conduct."); Peter Rybolt, *Causation and the Role of the Damages Expert*, 20 COM. & BUS. LITIG. 16, 17–19 (2018) (distinguishing proximate cause and factual cause, and discussing test of causation).

[40] Factual causation as a component of loss causation must be distinguished from transaction causation, which is also often (somewhat misleadingly) described as "factual causation." Loss causation is the causal connection between the defendant's violation and the plaintiff's economic loss, and transaction causation is the causal connection between the defendant's violation and the plaintiff's decision to enter into the transaction in question. Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974). *See also* Gary R. Edson, *Causation in Rule 10b-5 Actions for Corporate Mismanagement*, 48 UNIV. CHI. L. REV. 936 n.67 (1981) ("Transaction causation is said to test whether the defendant's violation caused the transaction; loss causation is said to test whether the violation caused the injury alleged."); *FindWhat Investor Group v. Findwhat.com*, 658 F.3d 1282, 1311 (11th Cir. 2011) ("While reliance focuses on the front-end causation question of whether the defendant's fraud induced or influenced the plaintiff's stock purchase, loss causation provides the 'bridge between reliance and actual damages.' ") (citation omitted).

[41] *See, e.g.*, *Dura*, 544 U.S. at 347 (to establish loss causation, investors must show that the revelation or materialization of the fraud caused a stock price decline); Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005) (plaintiffs may establish loss causation by showing that the defendant's misstatements concealed a foreseeable risk that materialized and caused a stock price decline); Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330, 334 (5th Cir. 2010) ("Plaintiff was required to prove loss causation, i.e., that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses."); *Id.* at 336–37 ("Causation . . . requires the Plaintiff to demonstrate the joinder between an earlier false or deceptive statement, for which the defendant was responsible, and a subsequent corrective disclosure that reveals the truth of the matter, and that the subsequent loss could not otherwise be explained by some additional factors revealed then to the market."); Oscar Priv. Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 270 (5th Cir. 2007) (to establish loss causation, "plaintiff[s] must prove 'that it is more probable than not that [the corrective disclosure specifically linked to the original fraud], and not other unrelated negative statements, that caused a significant amount of the [stock price] decline.' ") (quoting Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 666 (5th Cir. 2004)); Greenberg, 364 F.3d at 662 (5th Cir. 2004) (noting that loss causation may be established by showing a "decrease in price following the revelation of the misleading nature of . . . [prior] statements"); John C.P. Goldberg & Benjamin C. Zipursky, *The Fraud-on-the-Market Tort*, 66 VAND. L. REV. 1755, 1767 (2013) ("*Dura* further holds that even where the right sort of loss is pleaded, the defendant's misrepresentation must also bring about that loss in the right way—through the market's reaction to the revelation of the defendant's misrepresentation, rather than through forces operating independently of the misrepresentation."); Fisch, *supra* note 2, at 825 ("Although *Dura* did not explicitly require a corrective disclosure, the loss causation analysis in most cases has focused on both the identification of an adequate corrective disclosure and expert testimony tying that corrective disclosure to a drop in stock price.").

[42] *See, e.g.*, Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse Sec. (USA) LLC, 752 F.3d 82, 86 (1st Cir. 2014), noting that:

> The usual—it is fair to say 'preferred'—method of proving loss causation in a securities fraud case is through an event study, in which an expert determines the extent to which the changes in the price of a security result from events such as disclosure of negative information about a company, and the extent to which those changes result from other factors.

significant change in the stock price of the company.[43] In securities fraud litigation, event studies measure the impact of a corrective disclosure on a firm's stock price. The study first determines whether the corrective disclosure was associated with a statistically significant decline in the stock price of the security at issue.[44] It then adjusts the price decline for factors unrelated to the fraud to determine what portion of the price decline was factually caused by the corrective disclosure.[45]

Courts have accepted event studies showing a "statistically significant, market-adjusted negative price change at the time of the corrective disclosure" as evidence of loss causation.[46] In fact, event studies have become the "usual and preferred" method of proving loss causation in securities cases.[47] Some courts have rejected testimony by experts who failed

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[43] *See, e.g.*, Michael J. Kaufman & John M. Wunderlich, *Regressing: The Troubling Dispositive Role of Event Studies in Securities Fraud Litigation*, 15 STAN. J. L. BUS. & FIN. 183, 195 (2009).

[44] *See, e.g.*, Allen Ferrell & Atanu Saha, Discussion Paper, *Forward-Casting 10b-5 Damages: A Comparison to Other Methods*, HARV. U. JOHN M. OLIN CENTER FOR ECON. L. & BUS. 1, 6 (2011), explaining that:

The first step virtually always undertaken by plaintiffs in arriving at a damage estimate . . . is to conduct an event study to determine whether there was a statistically significant stock price reaction to the corrective disclosure(s) that cannot be attributed to non-firm specific events, such as general stock price movements on that day.

In re REMEC Inc. Sec. Litig., 702 F. Supp. 2d 1202, 1266 (S.D. Cal. 2010) (stating that to establish loss causation, an event study must show a "decline in stock price caused by the revelation of that truth [is] statistically significant").

[45] *See, e.g.*, Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse First Boston, 853 F. Supp. 2d 181, 190 (D. Mass. 2012), *aff'd sub nom. Bricklayers & Trowel Trades Int'l Pension Fund*, 752 F.3d at 82, the court explained:

> An event study that fails to disaggregate the effects of confounding factors must be excluded because it misleadingly suggests to the jury that a sophisticated statistical analysis proves the impact of defendants' alleged fraud on a stock's price when, in fact, the movement could very well have been caused by other information released to the market on the same date.

David H. Topol, *Attacking Plaintiffs-Style Damages During Mediation of Securities Cases*, 17 PLUS J. 1, 3 (May & June 2004), outlining the importance of an event study:

> An event study is necessary because the stock price of a company can rise or fall during the class period and immediately after the class period for three different reasons that have nothing to do with the fraud at issue: (1) general economic developments (*e.g.*, a stock market bubble), (2) factors specific to the economic sector in which the company competes, and (3) company-specific events that are unrelated to the alleged fraud (*e.g.*, management turnover, mergers, development of a new product).

[46] *See* Edward G. Fox, Merritt B. Fox & Ronald J. Gilson, *Economic Crisis and the Integration of Law and Finance: The Impact of Volatility Spikes*, 116 COLUM. L. REV. 325, 367, n.108 (2016) (noting that the "plaintiff must show . . . economic loss occurred after the truth behind the misrepresentation or omission became known to the market" and "decline in stock price caused by the revelation . . . must be statistically significant") (citing *In re* REMEC Inc. Sec. Litig., 702 F. Supp. 2d 1202, 1266, 1275 (S.D. Cal. 2010)); *In re* Imperial Credit Indus. Inc. Sec. Litig., 252 F. Supp. 2d 1005, 1015–16 (C.D. Cal. 2003) (granting defendant issuer's motion for summary judgment because plaintiff failed to provide "event study or similar analysis . . . [to] eliminate that portion of the price decline . . . which is unrelated to the alleged wrong" and is instead attributable to "market events for which Defendants cannot be held responsible"), *aff'd sub nom.* Mortensen v. Snavely, 145 F. App'x 218 (9th Cir. 2005). *See also In re* Vivendi Universal, S.A. Sec Litig, 634 F. Supp. 2d 352, 364 (S.D.N.Y. 2009) (referring to "the almost obligatory 'event study' that begins by isolating stock declines associated with market-wide and industry-wide downturns from those specific to the company itself").

[47] *See, e.g.*, *Bricklayers & Trowel Trades Int'l Pension Fund*, 752 F.3d at 86; Oscar Priv. Equity Invs. v. Allegiance Telecom, 487 F.3d 261, 271 (5th Cir. 2007) (rejecting as insufficient to show loss causation "the raw opinion of analysts, without supporting study of the market at issue—such as now common use of basic principles of econometrics"); Kaufman & Wunderlich, *supra* note 43, at 208 ("[T]he federal courts have held that the only way to link [post-corrective disclosure] price movement to the defendant's fraud is through an event study analysis.").

to perform an event study[48] or submitted an event study based on a flawed methodology.[49]

If a court finds that but-for the defendant's wrongdoing the plaintiff's injury would not have occurred, then the court inquires further whether there is proximate cause.[50] Proximate cause may be broadly (if somewhat tautologically) defined as "a reasonably close connection between a defendant's wrongdoing and the plaintiff's injury."[51] It is a liability-limiting doctrine that protects defendants from liability for consequences that as a matter of "fairness, policy, and practicality" fall beyond the scope of their moral accountability.[52]

The liability-limiting function of proximate cause is implemented by two doctrines: the "reasonable foresight" doctrine and the "direct consequences" doctrine.[53] The reasonable foresight doctrine examines whether the type of

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[48] *See, e.g.*, Fecht v. N. Telecom Ltd. (*In re* Northern Telecom Ltd. Sec. Litig.), 116 F. Supp. 2d 446, 460 (S.D.N.Y. 2000) (expert's testimony is "fatally deficient in that he did not perform an event study or similar analysis"); *In re* Exec. Telecard Sec. Litig., 979 F. Supp. 1021, 1025 (S.D.N.Y. 1997) (concluding that the "reliability of the Expert Witness' proposed testimony is called into question by his failure to indicate . . . whether he conducted an 'event study' ").

[49] *See, e.g.*, *In re* Omnicom Grp., Inc. Sec. Litig., 541 F. Supp. 2d 546, 554 (S.D.N.Y. 2008) (rejecting an event study that adjusted for only some but not all of the potentially confounding factors as insufficient "to establish that the alleged misrepresentations actually caused Plaintiffs' loss.").

[50] Robert A. Prentice, *Behavioral Economics Applied: Loss Causation*, 44 LOY. UNIV. CHI. L.J. 1509, 1513–14 (2013), outlining the causation analysis:

> If courts can say that "but for" the defendant's wrong the plaintiff's injury would not have occurred, then courts look to the second requirement, inquiring as "to whether there is *proximate cause* [or *loss causation*], an inquiry driven by policy considerations such as whether the law should hold the defendant legally responsible for the harm caused by the defendant's [wrong]."

(quoting Justin D. Levinson & Kaiping Peng, *Different Torts for Different Cohorts: A Cultural Psychological Critique of Tort Law's Actual Cause and Foreseeability Inquiries*, 13 S. CAL. INTERDISC. L.J. 195, 200 (2004)).

[51] David G. Owen, *The Five Elements of Negligence*, 35 HOFSTRA L. REV. 1671, 1681 (2007); Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997) (requiring the plaintiff to show that the defendant's fraud caused the loss "in some reasonably direct, or proximate, way" (quoting Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981))).

[52] *See, e.g.*, Holmes v. Sec. Inv. Prot. Corp., 503 U.S. 258, 268 (1992) (referring to proximate cause as a generic name for a set of tools courts "[use] to limit a person's responsibility for the consequences of that person's own acts"); CSX Transp., Inc. v. McBride, 564 U.S. 685, 692 (2011) (describing proximate cause as "shorthand for a concept: Injuries have countless causes, and not all should give rise to legal liability."); Owen, *supra* note 51; David G. Owen, *Figuring Foreseeability*, 44 WAKE FOREST L. REV. 1277, 1294 (2009); Mark F. Grady, *Proximate Cause Decoded*, 50 UCLA L. REV. 293, 315 n.71 (2002) (describing proximate cause as a "liability-limiting doctrine . . . [that] creates an impact only by barring liability"); Richard W. Wright, *Causation in Tort Law*, 73 CALIF. L. REV. 1735, 1741 (1985) ("Causation is *not* equivalent to responsibility."); DAN B. DOBBS, PAUL T. HAYDEN & ELLEN M BUBLICK, THE LAW OF TORTS 686–87 (2d ed. 2011) ("The function of proximate cause rules is to facilitate or express a value judgment about the appropriate scope of liability of a defendant who is negligent and whose negligence in fact causes harm."); Fox, *supra* note 21, at 831, explaining the purpose of loss causation:

> The function of the loss causation requirement, like the function of proximate cause in actions for negligence, was to prevent the wrongdoer from being responsible for all the consequences for which his action was a "but for" cause, i.e., all the losses, however unrelated to the misstatement, that the plaintiff might suffer over time as a result of purchasing this security.

Levinson & Peng, *supra* note 50, at 200 ("[The inquiry as] to whether there is proximate cause [or loss causation], [is] an inquiry driven by policy considerations such as whether the law should hold the defendant legally responsible for the harm caused by the defendant's [wrong].").

[53] Mark F. Grady, *Causation and Foreseeability*, *in* RESEARCH HANDBOOK ON THE ECONOMIC ANALYSIS OF TORTS 114, 136 (Jennifer H. Arlen ed., 2013) ("[T]he traditional doctrine of proximate cause represents two branches that must both be satisfied: the reasonable-foresight doctrine and the direct-consequences doctrine."); DOBBS ET AL., *supra* note 52, at 451–70, describing proximate causation in the law:

> When there is a sequence of events leading to the plaintiff's injury, in order to hold the defendant liable for damages, the cardinal rule of proximate causation in tort law is that the plaintiff's harm

harm suffered by the plaintiff was reasonably foreseeable at the time of the defendant's wrongdoing.[54] The direct consequences doctrine examines the concurrent efficient causes[55] of a plaintiff's harm to see whether an intervening cause supersedes the challenged conduct and cuts off the defendant's liability.[56] Both doctrines must be satisfied for proximate cause to exist. The plaintiff's loss must be both directly caused by the challenged conduct and be a reasonably foreseeable result of it.[57]

The direct consequences doctrine discharges liability in two types of situations:[58]

(1) An independent intervening cause of the plaintiff's harm supersedes the challenged conduct and breaks the causal chain.[59]

(2) A wrongdoer who creates a risky situation may escape liability when an intervening person (who has a duty to take a precaution against the risk that threatens a plaintiff) recklessly or intentionally fails to do so. The original wrongdoer escapes liability, and the intervening person becomes solely liable for the harm that they failed to prevent.[60]

The two situations are known respectively as the *superseding causation* paradigm and the *no corrective precaution* paradigm.[61]

Following Supreme Court precedent in *Dura* requires interpreting loss causation to replicate the meaning of traditional proximate cause, *translated*

> must have been the direct (as opposed to the indirect or remote) and foreseeable (as opposed to unforeseeable) consequence of the defendant's acts in a causal chain of events, unbroken by any intervening, superseding cause.

[54] *See, e.g.*, Owen, *supra* note 51, at 1683 ("Under [the reasonable foresight] test, the responsibility of an actor for the consequences of wrongful action is limited by principles of reasonable foreseeability."); Grady, *supra* note 52, at 299.

[55] Grady, *supra* note 52, at 299 ("A single accident can have several causes in fact, each of which was necessary to produce the harm. This is the definition of *concurrent efficient causes*.") (emphasis added).

[56] *Id.* at 299 ("The direct consequences doctrine . . . examines concurrent causes [of the plaintiff's loss] to see whether the person responsible for [an intervening cause] has cut off the liability of the person responsible for the first cause.").

[57] *See, e.g.*, Peter N. Swisher, *Causation Requirements in Tort and Insurance Law Practice: Demystifying Some Legal Causation "Riddles"*, 43 TORT TRIAL & INS. PRAC. L.J. 1, 12 (2007), explaining proximate cause:

> When there is a sequence of events leading to the plaintiff's injury, in order to hold the defendant liable for damages, the cardinal rule of proximate causation in tort law is that the plaintiff's harm must have been the direct (as opposed to the indirect or remote) and foreseeable (as opposed to unforeseeable) consequence of the defendant's acts in a causal chain of events, unbroken by any intervening, superseding cause.

(citing W. PAGE KEETON, DAN B. DOBBS, ROBERT E. KEETON & DAVID G. OWEN, PROSSER AND KEETON ON TORTS 272–300 (5th ed. 1984)); First Nationwide Bank v. Gelt Funding Corp., 27 F.3d 763, 769 (2d Cir. 1994) ("Many considerations enter into the proximate cause inquiry including 'the foreseeability of the particular injury, the intervention of other independent causes, and the factual directness of the causal connection.' ") (citing Brandenburg v. Seidel, 859 F.2d 1179, 1189 (4th Cir. 1988), *abrogated by* Quackenbush v. Allstate Ins. Co., 517 U.S. 706 (1996)).

[58] *See infra* notes 175–179 and accompanying text.

[59] *See infra* notes 180–198 and accompanying text.

[60] *See infra* notes 210–238 and accompanying text.

[61] *See* Grady, *supra* note 51, at 315, 319.

into a securities fraud environment.[62] *Fidelity in translation* is a concept created by Professor Lawrence Lessig as a metaphor for interpretation of a text that preserves its meaning across different contexts.[63] Professor John McGinnis explains, "[w]hile complicated in execution, the theory [of translation] at its core is stated simply: The social facts of the world change and these changes transform the context of legal texts. To be faithful to their original meaning, we must translate the text in light of this new context."[64]

The "original meaning" of traditional proximate cause that must be preserved in translation refers to its "underlying purpose, function, or design."[65] The liability-limiting function of proximate cause, as its core policy goal[66] and raison d'être,[67] defines the meaning that must be preserved. This policy goal is carried out by the reasonable foresight and direct consequences doctrines. To preserve the meaning of traditional proximate cause, loss causation must be governed by these doctrines, translated into a fraud-on-the-market context.[68] The Article develops this interpretation and analyzes its application in securities fraud litigation. The analysis shows that the liability-limiting doctrines of proximate cause translate into the following set of rules:[69]

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[62] Professor Lawrence Lessig describes translation as "capturing the essence" of judicial decision-making. *See* Lawrence Lessig, *Fidelity and Constraint*, 65 FORDHAM L. REV. 1365, 1432 (1997), the author describes:

> Translation captures, I suggest, the essence of the judge's task; it advises a creativity in recapturing what was said, it cautions a certain humility to assure that a translation says only what was said. It tracks well much of the shifts that constitutional law has seen; it understands them as efforts, however imperfect, at recapturing and preserving values from a different place, and time.

[63] LAWRENCE LESSIG, FIDELITY & CONSTRAINT: HOW THE SUPREME COURT HAS READ THE AMERICAN CONSTITUTION 771 (2019) (Translation produces an interpretation of an original text in the current context that preserves the meaning of the original text in its original context). *See also* John O. McGinnis, *The Inevitable Infidelities of Constitutional Translation: The Case of the New Deal*, 41 WM. & MARY L. REV. 177, 177 (1999-2000) ("Professor Lawrence Lessig's theory of fidelity in translation has been perhaps the most celebrated idea in constitutional interpretation since the democracy-reinforcing theory of Professor John Hart Ely in Democracy and Distrust.")

[64] McGinnis, *supra* note 63, at 177. *See also* Lawrence Lessig, *Understanding Changed Readings: Fidelity and Theory*, 47 STAN. L. REV. 395, 406 (1995) ("[The translator in law] constructs a *reading* in the second context to preserve the meaning of a *reading* within the first, where, again, the context within which both readings are made includes a legal text and a context background to that text."); Amul R. Thapar & Joe Masterman, *Fidelity and Construction*, 129 YALE L.J. 774, 779 (2020) ("Fidelity to meaning requires finding and applying that meaning.").

[65] *See* Jack M. Balkin, *Translating the Constitution*, 118 MICH. L. REV. 977, 979 (2020) ("[Translation] does not require that we preserve the original semantic meaning or the original communicative content of the text. Rather, it demands that we preserve the underlying purpose, function, or design behind the text in the new context.").

[66] Sandra F. Sperino, *Statutory Proximate Cause*, 88 NOTRE DAME L. REV. 1199, 1227 (2013) ("[T]he core concern of proximate cause is limiting liability.").

[67] Grady, *supra* note 52, at 315 n.71 ("A liability-limiting doctrine, such as proximate cause, creates an impact only by barring liability."); *see also* Sperino, *supra* note 64, at 1236 ("[P]roximate cause does not have a fixed meaning or goal, outside of a general principle of limiting liability.").

[68] *See, e.g.*, Laurence A. Steckman et al., *Loss Causation, Economic Loss Rules and Offset Defenses – Dismissal Motion Practice After Acticon A.G. v. China Northeast Petroleum Holdings Ltd.*, 31 TOURO L. REV. 501, 516 (2015), describing loss causation:

> The policy behind loss causation is the same as that which underlies the concept of tort law proximate causation, namely avoidance of recovery of potentially unlimited damage claims that would contravene public policy and turn errant defendants into windfall guarantors. It does so by precluding recovery when injury was neither foreseeable nor a direct (causal) result of the challenged conduct.

[69] *See infra* Sections III.B and III.C.

- The basic test of the reasonable foresight doctrine is whether one can see a systematic relationship between the alleged fraud and the corrective disclosure that reset the fraud-distorted stock price.
- Under the superseding cause paradigm, there is no loss causation if a factual cause of the stock price decline on which the plaintiff's loss causation theory is predicated is not systematically related to the challenged conduct.
- Under the no corrective precaution paradigm, a perpetrator of fraud will not be liable for that part of the plaintiff's loss caused by the plaintiff's own failure to preserve their investment when they first learned of the defendant's fraud, or had reason to know of it.
- The price decline on which the plaintiff's loss causation and damages theories are predicated must be adjusted for factors unrelated to the fraud. This is mandated by the factual cause component of loss causation.

Each rule limits the defendant's liability in some way. Together, the rules constitute a translation of the liability-limiting function of the traditional tort doctrines of factual and proximate cause into a fraud-on-the-market context. A classic securities fraud case with a simple fact scenario and direct link between the alleged fraud and a corrective disclosure does not usually present complex loss causation issues.[70] The analysis and methodology developed in the Article are most valuable when applied to cases with complex fact patterns.

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[70] *See, e.g.*, Warren R. Stern, *Loss Causation Update: Corrective Disclosure, Relevant Truth and the Flowserve Decision*, 6 SEC. LITIG. REP. 11, 12 (2009), the author explains:

> Loss causation is clearest when a corrective disclosure—for example, an accounting restatement—reveals a prior misrepresentation and is followed by a price drop not readily explained by other factors. But what if the disclosure is not a *mea culpa*? In such a case, plaintiffs have to show that the relevant truth was revealed to the market and cannot rely on the assertion that the company's 'true financial condition' was somehow revealed.

In re Williams Sec. Litig. – WCG Subclass, 558 F.3d 1130, 1137 (10th Cir. 2009) ("Loss causation is easiest to show when a corrective disclosure reveals the fraud to the public and the price subsequently drops—assuming, of course, that the plaintiff could isolate the effects from any other intervening causes that could have contributed to the decline."); Lyle Roberts, *The Ninth Circuit's Recent Decisions on The Pleading of Loss Causation in Securities Fraud Cases*, 54 REV. SEC. & COMMODITIES REG. 1, 1 (May 19, 2021), illustrating the impact of false statements on loss causation cases:

> Pleading loss causation can be straightforward when a false statement by a company causes its stock's price to rise and then the company makes a corrective disclosure and the price falls. For example, a company says it discovered gold, its stock price goes up $10, then a few months later the company admits it was fool's gold, and its stock price goes down $10. For an investor who bought after the false statement was made and before the corrective disclosure, the causal connection between the false statement and the economic loss associated with the stock price drop should not be difficult to establish. In real life, however, the facts are rarely that simple.

Meiring de Villiers, *Rule 10b-5 Meets Wagon Mound: A New Perspective on Loss Causation*, 23 MINN. J.L. SCI. & TECH. 447, 447–48 (2022), describing the role of Rule 10b-5 in loss causation:

> In a classic securities fraud class action, Rule 10b-5 cognizable fraud—such as the concealment of material information in violation of a duty to disclose—distorts the market price of a security, causing an investor to purchase securities at an artificially inflated price. A disclosure event, such as the materialization of a concealed risk, eventually signals the truth to the market and the investor suffers a loss when the share price declines.

(footnotes omitted).

The Article is organized as follows. Part I presents an overview of the private right of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission. Part II reviews the common law evolution of loss causation and its ultimate codification in the Private Securities Litigation Reform Act of 1995. Part III, the analytical core of the Article, develops and analyzes the translation that defines loss causation in a fraud-on-the-market context. A final section provides concluding comments.

I. OVERVIEW OF SECTION 10(B) AND RULE 10B-5

A defrauded investor may bring a private action for securities fraud under Section 10(b) of the Securities Exchange Act of 1934[71] and Rule 10b-5 of the Securities and Exchange Commission.[72] Section 10(b) broadly prohibits manipulative or deceptive conduct connected with the purchase or sale of a security. Under Section 10(b), it is unlawful to:

> [U]se 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 prescribe as necessary or appropriate in the public interest or for the protection of investors.[73]

In 1942, the SEC promulgated Rule 10b-5 under authority granted by Section 10(b).[74] Rule 10b-5 makes it unlawful:

(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.[75]

An implied private right of action for securities fraud under Rule 10b–5 was first recognized in *Kardon v. National Gypsum Co.*[76] Other courts followed suit,[77] and in 1971 the Supreme Court approved the private cause

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[71] 15 U.S.C. § 78j(b).

[72] 17 C.F.R. § 240.10b-5 (2023).

[73] 15 U.S.C. § 78j(b).

[74] THOMAS LEE HAZEN, FEDERAL SECURITIES LAW 113 (3d ed., 2011) ("Rule 10b-5 was promulgated under § 10(b), which gives the SEC power to make rules prohibiting the use of 'manipulative or deceptive device[s] or contrivance[s] . . . in connection with the purchase or sale of any security. . . .' ").

[75] 17 C.F.R. § 240.10b-5 (2023).

[76] Kardon v. Nat'l. Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) ("[I]n 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.").

[77] *See, e.g.*, LOUIS LOSS, SECURITIES REGULATION 1049–50 (1951) (The *Kardon* court's recognition of an implied cause of action "has . . . been followed in almost two score other cases" and "[n]o judge has expressed himself to the contrary").

of action.[78] Section 10(b) and Rule 10b-5 are now the most widely used anti-fraud provisions in federal securities law.[79]

A Rule 10b-5 plaintiff must plead and prove the following elements: (1) a material misrepresentation or omission; (2) scienter, namely a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation.[80]

The sixth element, loss causation, is the focus of this Article.

II. LOSS CAUSATION

To prevail on a claim under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission, the defrauded plaintiff must prove loss causation, broadly defined as a causal connection between a defendant's fraud and the plaintiff's economic loss.[81] Neither the Securities Exchange Act of 1934 nor SEC Rule 10b-5 specified loss causation as an element of a securities fraud action. It is a judicially created element that is rooted in the common law. [82] This section reviews the common law evolution and eventual codification of the loss causation element.

Loss causation is one of the most commonly litigated issues in securities fraud actions, featuring prominently in every phase of a securities fraud case, including pleadings, class certification, summary judgment, trial, appeals and other post-trial motions.[83] It has long been a requirement in common law

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[78] Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971)*; see also* HAZEN, *supra* note 37, at 441 (describing the evolution of implied right of action under Rule 10b-5).

[79] *See, e.g.*, Buell, *supra* note 9 at 540 ("[Rule 10b-5] can make a plausible claim to being the most consequential piece of American administrative law."); Hill, *supra* note 9, at 2666 ("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 l0b-5.").

[80] Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 267 (2014); Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

[81] *Dura*, 544 U.S. at 342 (defining loss causation as "a causal connection between the material misrepresentation and the [plaintiff's] loss" (citing 15 U.S.C. § 78u–4(b)(4)))*; see also* Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of* Dura Pharmaceuticals, Inc. v. Broudo, 63 BUS. LAW. 163, 163 (2007).

[82] *See, e.g.*, Fisch, *supra* note 2, at 815 ("The federal courts . . . have used federal common law to define the contours of the [10b-5] cause of action. Thus, the elements of a federal securities fraud claim, including the causation requirement, are largely judge-made law."); Ryan S. Thorson, *Securities Law-The Artificially Inflated Purchase Price Theory: An Economically Sound Yet Legally Insufficient Method of Pleading and Proving Loss Causation, Dura Pharmaceuticals v. Broudo*, 6 WYO. L. REV. 623, 628 (2006) ("Loss causation was not an element of a securities fraud cause of action under either the Securities Exchange Act of 1934 or under SEC Rule 10b-5. Loss causation is a judicially created element of a securities fraud action, and . . . it has historical roots in the common law."); Evan P. Singer, *Pleading and Proving Loss causation – Lessons From The Fifth Circuit*, in 2(9) SEC. LIT. & ENF'T (BL) 15 (May 3, 2010), explaining the impact of the Court's *Dura* ruling:

> [T]he [Dura] Court's unanimous opinion did not provide much detail on what must be shown to establish loss causation in a securities fraud case . . . . [T]he Supreme Court's opinion in Dura left room for the circuit courts to develop their own requirements for pleading and proving loss causation.

[83] Jordan Eth & Su-Han Wang, *Recent Developments in Loss Causation*, *in* HANDLING A SECURITIES CASE 2013: FROM INVESTIGATION TO TRIAL AND EVERYTHING IN BETWEEN 252 (PLI Corp. L. & Prac., Course Handbook Ser. No. B-2021 (2013)); Charles F. B. McAleer, Jr. & Yvonne M. Williams, *Loss Causation: A Durable Concept*, 13 BUS. TORTS J. 12, 12 (2006) ("Nowhere in the law have causation issues received more attention than in fraud cases, particularly securities fraud cases.").

actions for misrepresentation and deceit,[84] but *Schlick v. Penn-Dixie Cement Corp.*[85] was the first Circuit opinion to recognize loss causation as a distinct element of a Rule 10b-5 action.[86] The *Schlick* court explained that causation under Section 10(b) consists of two necessary and independent components: transaction causation and loss causation.[87] The court defined loss causation as the causal connection between the defendant's violation and the plaintiff's economic loss.[88] The court defined transaction causation as the causal connection between the defendant's violation and the plaintiff's decision to enter into the transaction in question.[89]

In *Huddleston v. Herman & MacLean*[90]—an opinion referred to as "the progenitor of most of the 10(b) loss causation cases in the district and circuit courts"[91]—the Fifth Circuit illustrated the difference between transaction and loss causation with the following example:

> An investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel had a certain capacity when in fact it had less capacity than was represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as a result of a casualty and the stock becomes worthless.[92]

A district court analyzing this example explained "the investor might be able to prove transaction causation (that the misrepresentation about the vessel's capacity induced him or her to purchase the stock), but could not prove loss causation (that the misrepresentation caused the investor's loss). The loss was caused by the lack of insurance."[93]

The Private Securities Litigation Reform Act of 1995 ("PSLRA") codified the loss causation requirement by adding Section 21D(b)(4) to the

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[84] Ferrell & Saha, *supra* note 81 (finding that if "no injury is occasioned by the lie, it is not actionable") (citing Pasley v. Freeman, (1789) 100 Eng. Rep. 450, 457 (K.B.)); *Dura*, 544 U.S. at 344 (discussing how "loss causation" is a requirement in common law deceit and misrepresentation actions).

[85] Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974).

[86] *See id.*; Ferrell & Saha, *supra* note 81; Fisch, *supra* note 2, at 864 (describing the *Schlick* court as "the source of the causation requirement in federal securities fraud").

[87] *Schlick*, 507 F.2d at 380.

[88] *Id.*

[89] *Id. See also* FindWhat Inv. Grp. v. Findwhat.com, 658 F.3d 1282, 1311 (11th Cir. 2011) ("While reliance focuses on the front-end causation question of whether the defendant's fraud induced or influenced the plaintiff's stock purchase, loss causation provides the 'bridge between reliance and actual damages.' "); Edson, *supra* note 40 ("Transaction causation is said to test whether the defendant's violation caused the transaction; loss causation is said to test whether the violation caused the injury alleged.").

[90] Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), *as corrected on denial of reh'g* (July 13, 1981), *aff'd in part, rev'd in part*, 459 U.S. 375 (1983).

[91] Ann Morales Olazábal, *Loss Causation in Fraud-on-the-Market Cases Post-Dura Pharmaceuticals*, 3(2) BERKELEY BUS. L.J. 337, 344–45 (2006); *see also* Michael J. Kaufman, *At a Loss: Congress, the Supreme Court and Causation Under Federal Securities Law*, 2 N.Y.U. J. L. & BUS. 1, 16 n.55 (2005) ("Although the term loss causation was actually first used by the court in *Schlick v. Penn-Dixie Cement Corp.,* 507 F.2d 374, 380 (2d Cir. 1974), the *Huddleston* decision was the first to identify the evidentiary burden created by 'loss causation.' ").

[92] *Huddleston*, 640 F.2d at 549 n.25.

[93] Smilovits v. First Solar, 119 F Supp. 3d 978, 987 (D. Ariz. 2015)*; see also* Ludlow v. BP, P.L.C., 800 F.3d 674, 681 (5th Cir. 2015) ("It is helpful to focus on three 'occurrences'—the misrepresentation, security transaction, and economic loss—and two 'relationships,' transaction causation, which links the misrepresentation and security transaction, and loss causation, which connects the misrepresentation to the economic loss.").

Securities Exchange Act of 1934.[94] It provides that plaintiffs in private fraud actions "shall have the burden of proving that the act or omission of the defendant . . . caused the loss for which the plaintiff seeks to recover damages."[95] The provision codifies the loss causation requirement but provides little guidance on interpreting, pleading, and proving loss causation.[96] The judiciary filled the legislative void, and the interpretation of loss causation evolved through judicial decision-making.[97]

The circuit courts were initially divided in their interpretation of the statutory requirement.[98] Under the majority view, loss causation required proof of a causal link between the defendant's fraud and the plaintiff's actual economic losses.[99] In contrast, a minority view held that plaintiffs need only show that the purchase price was inflated because of the misrepresentation.[100]

On April 19, 2005, the Supreme Court resolved the conflicts among the circuit courts in *Dura Pharmaceuticals*.[101] In a unanimous decision, the Court established that merely alleging price inflation due to a material misrepresentation or omission does not sufficiently plead loss causation in a fraud-on-the-market case.[102] Rather, the plaintiff must establish loss

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[94] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 21D(b)(4), 109 Stat. 737, 747 (codified at 15 U.S.C. § 78u-4(b)(4) (2006)).

[95] 15 U.S.C. § 78u-4(b)(4).

[96] *See, e.g.*, Olazábal, *supra* note 91, at 348 ("[The] loss causation [in the PSLRA] provision fails to clarify what properly suffices to plead or prove the causation element."); Jeffrey W. Stempel, *Class Actions and Limited Vision: Opportunities for Improvement Through a More Functional Approach to Class Treatment of Disputes*, 83 WASH. UNIV. L. Q. 1127, 1184 (2005) ("[T]he PSLRA requires only that there be proof of loss—it does not specify the acceptable methodologies for demonstrating such proof."); Fisch, *supra* note 2, at 813 n.6 ("Congress codified the loss causation requirement as part of the Private Securities Litigation Reform Act of 1995 without defining loss causation or evidencing any intention to depart from the existing judge-made definition."); Escoffery, *supra* note 25, at 1810 ("[T]he [PSLRA] does not provide a clear analytical approach to guide courts in determining whether a plaintiff has sufficiently pled loss causation.").

[97] Thorson, *supra* note 82, at 628–29 (2006); Kaufman, *supra* note 91, at 19 ("[C]ommon law fraud causation authorities guide the judicial construction of the PSLRA's loss causation language."); Devin F. Ryan, *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."); Buell, *supra* note 9, at 545 ("The law of securities fraud is one of the most heavily judicially created bodies of federal law.").

[98] Hill, *supra* note 9, at 2673–77.

[99] *See, e.g.*, Robbins v. Koger Props. Inc., 116 F.3d 1441, 1448 (11th Cir. 1997) ("Our decisions explicitly require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value."); Emergent Cap. Inv. Mgmt. v. Stonepath Grp., 343 F.3d 189, 192 (2d Cir. 2003) ("We think that the second amended complaint contains legally sufficient allegations of a causal connection between the subject matter of these omissions and the ultimate decline in NETV's stock value, that is, loss causation.").

[100] *See, e.g.*, Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996) ("[P]laintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation."); Broudo v. Dura Pharms., Inc., 339 F.3d 933, 938 (9th Cir. 2003), *rev'd*, 544 U.S. 336 (2005) ("[P]laintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation."); Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 832 (8th Cir. 2003) ("[t]he fraud-on-the-market theory . . . allow[s] the fact finder to presume that the stock's price reflected the inflated earnings, and it makes sense to conclude that the plaintiffs were harmed when they paid more for the stock than it was worth. This is a sufficient allegation.").

[101] Brief for Petitioners, Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005) (No. 03-932) 2004 U.S. S. Ct. Briefs LEXIS at *9 (The Supreme Court granted certiorari on the narrow question of "[w]hether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price").

[102] *Dura*, 544 U.S. at 346.

causation by pleading and proving a causal connection between the challenged conduct and the investment's subsequent decline in price.[103] The Court counseled lower courts to analyze the causal relationship in accordance with common law tort principles.[104] Scholars who analyzed the *Dura* decision observed that it "says no less than seven times that *proximate causation* is the standard for loss causation."[105] The Supreme Court's interpretation of loss causation as proximate cause is authoritative, but did not break new ground.[106] A majority of courts,[107] as well as academic

[103] *Id.* at 342.

[104] *See, e.g.*, Fisch, *supra* note 2, at 811 ("The Dura decision itself said little, but counseled lower courts to fashion new requirements of causation and harm modeled upon common law tort principles.").

[105] *See* Frederick C. Dunbar & Marcia Kramer Mayer, *Dura and the New Vocabulary of Litigation Under Rule 10b-5*, TECH. REP.,1, 14 n.21 (Jan 5, 2006).

[106] Ian Ackerman, *Forgive and Forget (The Efficient Amnesiac): Loss Causation in a Well-Developed Post Dura Market*, 25 ANN. REV. BANKING & FIN. L. 557, 566 (2006) (The *Dura* Court concluded "that Congress merely intended to codify the traditional loss causation or proximate cause requirement long applied by the courts") (citing Dura Pharms., Inc. v. Broudo, 544 U.S. at 346)); FRIEDMAN, KAPLAN, SEILER & ADELMAN LLP, *How Broad Are the Implications of the Supreme Court's Ruling on Loss Causation in Dura Pharmaceuticals?* (April 27, 2005) ("The [*Dura*] decision did not purport to announce a new rule or break new legal ground, and is consistent with longstanding authority in the Second Circuit and other U.S. Courts of Appeals.") https://www.fklaw.com/assets/htmldocuments/dura.pdf [https://perma.cc/TAR7-V3ZB].

[107] *See* Emergent Cap. Inv. Mgmt. v. Stonepath Grp., 343 F.3d 189, 197 (2d Cir. 2003) ("We have often compared loss causation to the tort law concept of proximate cause, 'meaning that the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material omission.' ") (citation omitted); Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 186 (2d Cir. 2001) ("While transaction causation is generally understood as reliance, loss causation has often been described as proximate cause, meaning that the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material omission." (citing Suez Equity. v. Toronto-Dominion Bank, 250 F.3d 87, 96 (2d Cir. 2001)); AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 226 (2d Cir. 2000) ("[L]oss causation closely corresponds to the common law principle of proximate cause."); Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb Inc., 967 F.2d 742, 747 (2d Cir. 1992); Mfr's Hanover Trust Co. v. Drysdale Sec. Corp., 801 F.2d 13, 20 (2d Cir. 1986) ("Loss causation embodies notions of "the common law tort concept of 'proximate causation.' "); Berckeley Inv. Grp. v. Colkitt, 455 F.3d 195, 222 (3d Cir. 2006) ("Causation in the securities context is strikingly similar to the familiar standard in the torts context, but with different labels. In the securities realm, . . . 'proximate cause' is known as 'loss causation.' "); Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) ("[A]n investor must also establish that the alleged misrepresentations proximately caused the decline in the security's value to satisfy the element of loss causation."); Tchr.'s Ret. Sys. v. Hunter, 477 F.3d 162, 185 (4th Cir. 2007) (In order to show loss causation, a plaintiff must prove that "the defendant's misrepresentations proximately caused the plaintiff's economic loss"); Huddleston v. Herman & MacLean, 640 F.2d 534, 549, n.24 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983) (defining loss causation as the plaintiff's proof that "the untruth was in some reasonably direct, or proximate, way responsible for his loss."); Mineworkers' Pension Scheme v. First Solar, Inc., 881 F.3d 750, 752 (9th Cir. 2018) (concluding that a general proximate cause test is the proper test for loss causation under the Securities Exchange Act of 1934.); Lloyd v. CVB Fin. Corp., 811 F.3d 1200, 1210 (9th Cir. 2016) ("Because loss causation is simply a variant of proximate cause, Dura, 544 U.S. at 343–46, the ultimate issue is whether the defendant's misstatement, as opposed to some other fact, foreseeably caused the plaintiff's loss."); Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997); Spreitzer v. Hawkeye State Bank, 779 N.W.2d 726, 742 (Iowa 2009) (holding that the plaintiff must establish "that the fact misrepresented increased the risk of the specific damages claimed.").

commentators[108] and practitioners,[109] have embraced the interpretation of loss causation as a proximate causal relation between a defendant's fraud and a plaintiff's economic loss.

A. POST-*DURA* EVOLUTION

The Supreme Court's decision in *Dura Pharmaceuticals* has been described as "the seminal pronouncement on the necessary showing of loss causation as a matter of both pleading and proof in fraud-on-the-market cases."[110] It addressed a crucial issue but left many questions unanswered.[111] An important and recurring issue left unresolved is whether loss causation can be established when the corrective disclosure did not reveal the *specific* fraud on which the claim is based.[112] The question has long divided the circuit courts.

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[108] *See* HAZEN, *supra* note 37, at 479–81 (describing the analysis of loss causation as similar to the analysis of proximate cause); Jason N. Haycock, *Pleading a Loss Cause: Resolving the Pleading Standard for the Element of Loss Causation in a Private Securities Fraud Claim and a Plaintiff 's Heavy Burden Pleading it Under IQBAL*, 60(1) AM. U.L. REV. 173, 182 (2010) ("Analytically, loss causation is often best understood as analogous to the tort element of proximate cause."); Morris & Outlaw, *supra* note 22 ("[T]he [*Dura*] Court emphasized the distinctness of the loss causation requirement, and placed that requirement squarely in the tradition of proximate cause law and scholarship."); Devin F. Ryan, *supra* note 97, at 509 ("[L]oss causation, the far more subtle stepchild of causation, is arguably analogous to the tort concept of proximate or legal causation."); Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits*, 2009 WIS. L. REV. 199, 218 (2009) ("The vast majority of courts have used the proximate cause standard, mentioned in *Dura* . . . . "); Bradford Cornell & James C. Rutten, *Collateral Damage and Securities Litigation*, 2009 UTAH L. REV. 717, 744 (2009) ("Loss causation is the securities law equivalent of proximate causation . . . ."); Hillary A. Sale & Robert B. Thompson, *Market Intermediation, Publicness and Securities Class Actions*, 93 WASH. U. L. REV. 487, 498 (2015) ("Loss causation responds to the legal and policy concerns that the plaintiffs should not be insured against market changes. This element plays the intervening or proximate cause role that the *Palsgraf* case plays in traditional tort cases."); Fisch, *supra* note 2.

[109] *See, e.g.*, David B. Saxe & Danielle C. Lesser, *Loss Causation in Securities Fraud Cases*, N.Y. L.J. 1, 1 (2017) ("Proximate cause is a vital element in negligence cases, but is also an important element in securities fraud cases, where it is known as loss causation.").

[110] *See* Robert N. Rapp, *Plausible Cause: Exploring the Limits of Loss Causation in Pleading and Proving Market Fraud Claims Under Securities Exchange Act § 10(b) and SEC Rule 10b-5*, 41 OHIO NORTHERN UNIV. L. REV. 389, 393 (2015).

[111] *See, e.g.*, Fox, *supra* note 21, at 865–74 (2006); Olazábal, *supra* note 89, at 379 ("*Dura* may be just as important for what it did not accomplish as for what little it said about loss causation."); Burch, *supra* note 20, at 350–51 (describing *Dura* as missed opportunity in which Court "muddied the water with regard to what constituted loss."); Morris & Outlaw, *supra* note 23, at 37; Acticon AG v. China North East Petrol. Holdings, Ltd., 692 F.3d 34, 40 (2d Cir. 2012) ("The [*Dura*] Court's holding, by its own terms, was quite limited.").

[112] *See, e.g.,* Morris & Outlaw, *supra* note 23.

The most restrictive (the First,[113] Fourth,[114] Seventh,[115] and Eleventh[116]) Circuits have held that a plaintiff can establish loss causation only by proving that the market learned of the specific fraud on which the claim is based and reacted to it. The Second,[117] Fifth,[118] Sixth,[119] and Tenth[120] Circuits have taken a less restrictive position. To establish loss causation in these jurisdictions, the plaintiff must show that the market learned the truth, not necessarily that it had been fraudulently concealed.

[113] *See, e.g.*, Mass. Ret. Sys. v. CVS Caremark Corp., 716 F.3d 229, 239–40 (1st Cir. 2013) (corrective disclosure must "reveal that [the defendant's] previous statements were misrepresentations").

[114] *See, e.g.*, Katyle v. Penn Nat'l Gaming, Inc., 637 F.3d 462, 473 (4th Cir. 2011) (requiring plaintiffs to identify disclosures that "reveal to the market in some sense the fraudulent nature of the [alleged fraud]"); Tchrs. Ret. Sys. v. Hunter, 477 F.3d 162, 187 n.3 (4th Cir. 2007) (stating that a plaintiff could successfully allege loss causation by pleading that a previously concealed risk materialized. This pleading is viable because "news of the materialized risk would itself be the revelation of fraud that caused plaintiffs' loss").

[115] *See, e.g.*, Glickenhaus & Co. v. Household Int'l, Inc., 787 F.3d 408, 414 (7th Cir. 2015) ("[P]laintiffs must show both that the defendants' alleged misrepresentations artificially inflated the price of the stock and that the value of the stock declined once the market learned of the deception.") (citing Ray v. Citigroup Glob. Mkts., 482 F.3d 991, 995 (7th Cir. 2007); Tricontinental Indus., v. PricewaterhouseCoopers, ... 475 F.3d 824, 844 (7th Cir. 2007) (finding that plaintiffs must show that they "experienced [a] loss as a result of the exposure of [the defendant's] misrepresentations."); Ray v. Citigroup Glob. Mkts., 482 F.3d 991, 995 (7th Cir. 2007) (explaining that misrepresentations proximately cause a loss only where "the market learned of the deception").

[116] Meyer v. Greene, 710 F.3d 1189, 1197–2000 (11th Cir. 2013) (agreeing that critical comments about a defendant company's finances could count as a disclosure of the company's accounting irregularities. The court concluded, however, that the plaintiffs had not met their burden because the comments "were not necessarily revelatory of any past fraud."); FindWhat Inv. Grp v. Findwhat.com, 658 F.3d 1282, 1311 n.28 (11th Cir. 2011) (holding that a "corrective disclosure can come from any source, and can 'take any form from which the market can absorb [the information] and react,' so long as it 'reveal[s] to the market the falsity of the prior misstatements' " (citing 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, 64–71 (2008) and Lentell v. Merrill Lynch & Co., 396 F.3d 161, 175 n.4 (2d Cir. 2005))).

[117] *See, e.g.*, *In re* Vivendi, S.A. Sec. Litig., 838 F.3d 223, 262 (2d Cir. 2016) (affirming a jury's loss causation finding because, "although no specific corrective disclosure ever exposed the precise extent of [the] alleged fraud, Plaintiffs' theory of loss causation nevertheless rested on the revelation of the truth."); *id.* ("Whether the truth comes out by way of a corrective disclosure describing the precise fraud inherent in the alleged misstatements, or through events constructively disclosing the fraud, does not alter the basic loss-causation calculus."); Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005) (describing loss causation as requiring "both that the loss be foreseeable and that the loss be caused by the materialization of the concealed risk").

[118] *See, e.g.*, Pub. Emp.'s. Ret. Sys. Of Miss. v. Amedisys, Inc., 769 F.3d 313, 320 (5th Cir. 2014) ("To establish proximate causation, the plaintiff must allege that when the 'relevant truth' about the fraud began to leak out or otherwise make its way into the marketplace, it caused the price of the stock to depreciate and, thereby, proximately caused the plaintiff's economic harm."); *id.* at 325 n.5 (rejecting the defendant's argument that a disclosure must "reveal the falsity in a prior statement," calling "[s]uch a standard . . . inconsistent with [its] prior precedent" (citing Lormand v. U.S. Unwired, Inc., 565 F.3d 228 (5th Cir. 2009))); Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 230 (5th Cir. 2009) (per curiam) ("[T]o establish loss causation this disclosed information must reflect part of the 'relevant truth'— the truth obscured by the fraudulent statements."); *id.* at 231 (reversing the district court's ruling that required a plaintiff to allege that revised earnings guidance "directly . . . reveal[ed]" that the defendant's prior "guidance was fraudulent." The court explained, "[t]hat is not required; it was enough that the market learned that the [earlier] guidance was wrong and that other negative information unrelated to the reduced . . . guidance did not cause the decline in [the defendant's] share price.").

[119] *See, e.g.*, Ohio Pub. Emps. Ret. Sys. v. Fed. Home Loan Mortg. Corp., 830 F.3d 376, 384–85 (6th Cir. 2016) (allowing plaintiffs to predicate loss causation on materialization of a concealed risk, even in the absence of disclosure of the prior misstatement or omission (quoting *In re* Omnicare, Inc. Sec. Litig., 769 F.3d 455, 469 (6th Cir. 2014))).

[120] *See, e.g.*, *In re* Williams Sec. Litig. – WCG Subclass, 558 F.3d 1130, 1139 (10th Cir. 2009) (finding that loss causation standard requires plaintiffs to "explain how the truth was revealed to the market" and then "link the revelation of truth to a corresponding loss"); Nakkhumpun v. Taylor, 782 F.3d 1142, 1154 (10th Cir. 2015).

The Third Circuit has taken the least restrictive position, essentially embracing a "pure" proximate cause standard.[121] Under Third Circuit precedent, a plaintiff can establish loss causation by proving a fact that causally connects the loss to the fraud, even if both the truth and the fact that it had been fraudulently concealed remained undisclosed during the class period.[122] A plaintiff may, for instance, predicate loss causation on a stock price decline coinciding with an earnings miss, even if the market was unaware *at the time* that the miss was due to accounting fraud, such as revenue overstatement.[123]

Following *Dura*, two irreconcilable lines of cases developed within the Ninth Circuit regarding the correct test for loss causation under Section 10(b). One group of Ninth Circuit rulings followed the most restrictive line, holding that loss causation can be established only if the specific fraudulent practices were revealed to the market, the market reacted to the revelation, and the plaintiff suffered a loss as a result of the market reaction.[124] A second group of rulings followed a more permissive approach, holding that loss causation can be established even when the corrective disclosure did not reveal the specific fraud on which the claim is based.[125]

On January 31, 2018, in *Mineworkers' Pension Scheme v. First Solar, Inc.*,[126] the Ninth Circuit resolved the split, holding that a general proximate cause test was the correct test for loss causation under the Securities Exchange Act of 1934, and there was no requirement that the defendant's

[121] McCabe v. Ernst & Young L.L.P., 494 F.3d 418, 426 (3d Cir. 2007) ("The loss causation inquiry asks whether the misrepresentation or omission proximately caused he economic loss." (citing Semerenko v. Cendant Corp., 223 F.3d 165, 187 (3d Cir. 2000))); Smilovits v. First Solar Inc., 119 F. Supp. 3d 978, 991 (2015) ("As explained in *Dura* and explored more thoroughly in *McCabe,* loss causation is a form of proximate cause. It was adopted by Congress to ensure that securities fraud plaintiffs may recover from defendants only when the actions of those defendants proximately cause the plaintiffs' loss." (citing *Dura*, 544 U.S. at 342–46, 366)).

[122] *See, e.g., McCabe*, 494 F.3d at 430 (holding that a plaintiff need only "trac[e] the loss back to the very facts about which the defendant lied," regardless of what the market knew (citing Caremark, Inc. v. Coram Healthcare Corp., 113 F.3d, 645, 648 (7th Cir. 1997))); Gallup v. Clarion Sintered Metals, Inc., 489 F. App'x 553, 556 (3d Cir. 2012); Daniel Roy Settana III, *Proving Economic Loss for in-and-out Traders in Light of First Solar*, 29 U. MIA. BUS. L. REV. 198, 208 (2021) ("Unlike the majority of Circuits, the Third Circuit does not require a corrective disclosure that reveals new information about a fraudulent misrepresentation; the Third Circuit requires that the underlying facts be a substantial factor in a plaintiff's economic loss.").

[123] In *McCabe*, the principals of an acquired company sued the acquiring company's auditors, claiming that the auditors had helped their client conceal past registration defaults. *McCabe*, 494 F.3d at 422. The plaintiffs did not contend that the auditors' alleged omissions had been revealed to the market during the class period. Instead, the plaintiffs predicated their loss causation theory on the company's "failure to meet its earnings and revenue targets . . . ." *Id.* at 435–36. The earnings and revenue misses did not reveal the specific fraud on which the plaintiffs' claim was based, but that fact presented no obstacle to the plaintiffs' loss causation theory. The Third Circuit held that "to survive summary judgment," the plaintiffs needed only "create a genuine issue as to whether . . . the very facts omitted by [the defendant] were a substantial factor in causing [their] economic loss." *Id.* at 436.

[124] *See, e.g.,* Metzler Inv. GMBH v. Corinthian Coll's, Inc., 540 F.3d 1049, 1063 (9th Cir. 2008) (finding that to claim loss causation, "the complaint must allege that the practices that the plaintiff contends are fraudulent were revealed to the market and caused the resulting losses."); *In re* Oracle Corp. Sec. Litig., 627 F.3d 376, 392 (9th Cir. 2010) ("[L]oss causation is not adequately pled unless a plaintiff alleges that the market learned of and reacted to the practices the plaintiff contends are fraudulent, as opposed to merely reports of defendant's poor financial health generally."); Oregon Pub. Emps. Ret. Fund v. Apollo Grp., 774 F.3d 598 (9th Cir. 2014); Loos v. Immersion Corp., 762 F.3d 880 (9th Cir. 2014).

[125] *See, e.g.,* Nuveen Mun. High Income Opportunity Fund v. City of Alameda, 730 F.3d 1111, 1120 (9th Cir. 2013) ("Disclosure of the fraud is not a sine qua non of loss causation, which may be shown even where the alleged fraud is not necessarily revealed prior to the economic loss."); Berson v. Applied Signal Tech., 527 F.3d 982 (9th Cir. 2008); *In re* Daou Sys., Inc. Sec. Litg., 411 F.3d 1006 (9th Cir. 2005).

[126] Mineworkers' Pension Scheme v. First Solar, Inc., 881 F.3d 750 (9th Cir. 2018).

fraud had been revealed to the market prior to the loss.[127] With the judgment in *First Solar*, the Ninth Circuit conclusively joined the Third Circuit at the least restrictive end of the test of loss causation.

In *First Solar,* the stock price of First Solar, one of the world's largest producers of photovoltaic solar panel modules, declined sharply upon release of financial statements disclosing defects in its electricity-generating products and related remediation expenses.[128] A group of investors in First Solar stock filed claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 against First Solar.[129] The plaintiffs alleged that First Solar had fraudulently concealed these defects, misrepresented the cost and scope of the defects, and understated the defects' financial impact.[130] Significantly, the defects and related expenses were revealed to the market during the class period, but the fraud itself—failure to timely disclose the defects and their financial impact—was revealed only after the class period had ended.[131] This fact was the crux of the issue before the district court: Must the market learn of and react to the actual fraud itself to prove loss causation?

Before the district court, the defendants moved for summary judgment on the plaintiffs' Section 10(b) claims, arguing that loss causation can be established only if "the market learns of a defendant's fraudulent act or practice, the market reacts to the fraudulent act or practice, and plaintiff suffers a loss as a result of the market's reaction."[132] The plaintiffs countered that their economic loss was proximately caused by the defendant's fraud, even though the fraud had not yet been revealed to the market at the time of the loss.[133] Both parties cited Ninth Circuit precedent in support of their respective positions.[134]

The district court observed that the authorities cited by the parties reflect "two irreconcilable lines of cases" that had emerged in the Ninth Circuit since the Supreme Court's decision in *Dura Pharmaceuticals*.[135] Perceiving that one line would result in summary judgment for the defendants on loss causation, while the other (which the court would ultimately choose to follow) would result in denial of summary judgment and a lengthy and

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[127] *Id.* at 751–52, the court explained:

> We consider the question certified by the district court for interlocutory appeal under 28 U.S.C. § 1292(b) as to the correct test for loss causation under the Securities Exchange Act of 1934. We conclude that a general proximate cause test—the test ultimately applied by the district court—is the proper test.

Id. at 754 ("That a stock price drop comes immediately after the revelation of fraud can help to rule out alternative causes. But that sequence is not a condition of loss causation." (citing *Dura*, 544 U.S. at 342–43; *Nuveen Mun. High Income Opportunity Fund*, 730 F.3d at 1120.)); *id.* ("A plaintiff may also prove loss causation by showing that the stock price fell upon the revelation of an earnings miss, even if the market was unaware at the time that fraud had concealed the miss.").

[128] Smilovits v. First Solar Inc., 119 F. Supp. 3d 978, 981 (2015).

[129] *Id.*

[130] *Id.*

[131] *Id.* at 984–85.

[132] *Id.* at 986 (citing *In re* Oracle Corp. Sec. Litig., 627 F.3d 376, 392 (9th Cir. 2010)).

[133] *Id.* at 986, 989 ("Disclosure of the fraud is not a sine qua non of loss causation, which may be shown even where the alleged fraud is not necessarily revealed prior to the economic loss." (quoting *Nuveen Mun. High Income Opportunity Fund*, 730 F.3d at 1120)); *id.* at 1120 ("A plaintiff can satisfy loss causation by showing that the defendant misrepresented or omitted the *very facts* that were a substantial factor in causing the plaintiff's economic loss.").

[134] *Id.* at 986.

[135] *Id.*

expensive trial, the court certified the issue for immediate interlocutory appeal pursuant to 28 U.S.C. § 1292(b).[136] Accordingly, the district court certified the following question:

> [W]hat is the correct test for loss causation in the Ninth Circuit? Can a plaintiff prove loss causation by showing that the very facts misrepresented or omitted by the defendant were a substantial factor in causing the plaintiff's economic loss, even if the fraud itself was not revealed to the market, or must the market actually learn that the defendant engaged in fraud and react to the fraud itself?[137]

In a concise per curiam opinion, the Ninth Circuit affirmed the district court's ruling.[138] The Circuit held that "a general proximate cause test . . . is the proper test" for loss causation under the Securities Exchange Act of 1934, and it is not required that the defendant's fraud was revealed to the market prior to the loss.[139]

III. PROXIMATE CAUSE

The Supreme Court precedent in *Dura* requires interpreting loss causation to replicate the *meaning* of traditional proximate cause, *translated* into a securities fraud environment.[140] This Part defines the meaning of proximate cause and develops its translation into a fraud-on-the-market environment.

A. FIDELITY IN TRANSLATION

Professor Lessig's theory of *fidelity in translation* has been described as "perhaps the most celebrated idea in constitutional interpretation since the democracy-reinforcing theory of Professor John Hart Ely in *Democracy and Distrust*."[141] It is a metaphor for the interpretation of a text that preserves its meaning across different contexts.[142] An example from Australian patent law illustrates the concept.

For a process to qualify as patentable subject matter under Australian patent law, it must have economic utility and result in an artificially created state of affairs.[143] This rule was established in a 1959 landmark decision by the Australian High Court, in *National Research Development Corporation v. Commissioner of Patents*[144] ("*NRDC*"). *NRDC* involved a patent application for a process that used a known chemical for a purpose for which it was *not* known to be useful—namely, killing weeds growing among fodder

[136] *Id.* at 981.
[137] Mineworkers' Pension Scheme v. First Solar Inc., 881 F.3d 750, 753 (9th Cir. 2018).
[138] *Id.* at 751–52.
[139] *Id.* at 752, 754.
[140] LESSIG, *supra* note 63, at 56, describing the use of translation in application of the law:

> "Translation" . . . is a device for rendering a text in a target context that preserves the meaning of the source text in the source context. As applied to the law, it is a device for rendering a reading of a text in the target context (usually a judicial opinion) that preserves the meaning of the source text (a statute, or . . . a constitution).

[141] *See* McGinnis, *supra* note 63, at 177.
[142] LESSIG, *supra* note 63.
[143] *See* Nat'l Rsch Dev Corp v Comm'r of Patents (1959) 102 CLR 252, 277 (Austl.).
[144] *Id*.

crops without damaging the crops. The court held that the claimed invention is patentable subject matter. The economic utility and artificiality requirements were both satisfied. The chemical had an artificial effect on the crops and weeds to which it was applied.[145]

The *NRDC* rule is still the predominant test for patentability in Australia,[146] but it raises questions about the interpretation of an ancient precedent in a modern information age. In particular, what does the concept "artificially created state of affairs" mean in the context of a computer software-related invention? The first major Australian case to consider software-related inventions as patentable subject matter was *IBM v. Smith, Commissioner of Patents*.[147]

In *IBM*, the court was asked to reconsider the refusal by the Delegate of the Commissioner of Patents to award a patent for an improved method of visually representing curve images in computer graphics displays.[148] The court translated the *NRDC* concept of "artificially created state of affairs" into a digital environment as "steps which are foreign to the normal functionality of computers."[149] The court held that the IBM method constitutes patentable subject matter, because production of the digital images involved steps and an end result that were "foreign" to the then-standard functionality of a computer.[150] The *IBM* court's translation of a rule between original and modern contexts speaks the language of a novel technological environment, yet preserves the original meaning and policy rationale of the rule. This is the essence of the translation doctrine.[151]

Translation of a text is a two-step process. The first step asks the question: what is the meaning of the text in its original context?[152] The second step constructs a text in the new context that is faithful to the meaning in the original context.[153] The meaning of a doctrine is defined by its "underlying purpose, function [and] design."[154] The translated version of the doctrine must preserve the meaning so defined.

[145] *Id.* (finding that the NRDC invention was patentable because it "cannot be classed as a variant of ancient [agricultural] procedures."); *see also Grant v of Patents* (2006) 154 FCR 62, 70 (Austl.) (stating that in *NRDC* "an artificial effect was physically created on the land").

[146] *See, e.g.*, *Joos v Comm'r of Patents* (1972) 126 CLR 611, 616 (Austl.); *CCOM Pty Ltd v Jiejing Pty Ltd* (1996) 21 FCR 260, 287 (Austl.).

[147] *IBM Corp. v Comm'r of Patents* (1991) 105 ALR 388 (Austl.).

[148] *Id.* at 390.

[149] *Id.* at 395.

[150] *Id.* at 395; *see also Rsch. Affiliates L.L.C. v Comm'r of Patents* [2013] FCA 71 (Austl.) (holding that a computer-implemented method of generating a financial index did not constitute patentable subject matter. Computerizing a formerly manual process did create not an artificial effect, because it is part of the normal functionality of a computer.).

[151] *See* Lawrence Lessig, *Fidelity in Translation*, 71 TEX. L. REV. 1165, 1217 (1993) ("[C]hange in light of changed presuppositions is the essence of fidelity [in translation].").

[152] Thapar & Masterman, *supra* note 64.

[153] *See* LESSIG, *supra* note 63, at 63–64 ("Translation itself is a two-step process. In the first step, the translator understands the text in its original context. In the second step, the translator then carries that first step meaning into the present or target context."). *See also* Thapar & Masterman, *supra* note 64, at 774 ("To determine meaning, . . . judges should engage in a two-step process: first determine the original meaning of the provision at issue, then translate that meaning into the modern context.").

[154] *See* Balkin, *supra* note 65.

Proximate cause is a liability-limiting doctrine.[155] The liability-limiting function of proximate cause, as its core policy goal[156] and raison d'être,[157] defines the meaning that must be preserved across contexts. The policy goal of proximate cause is carried out by the reasonable foresight and direct consequences doctrines.[158] To preserve the "underlying purpose, function [and] design" of traditional proximate cause, loss causation must therefore be governed by these doctrines, translated into a fraud-on-the-market context.[159] Sections III.B and III.C review the reasonable foresight and direct consequences doctrines and analyze their translation into and application in a fraud-on-the-market context.

B. Reasonable Foresight

The reasonable foresight doctrine asks whether the type of harm suffered by the plaintiff was foreseeable at the time of the defendant's wrongdoing.[160] The basic test of foreseeability is whether one can see a *systematic relationship* between the defendant's wrongdoing and the type of harm that had befallen the plaintiff.[161] An equivalent definition describes the plaintiff's harm as the foreseeable result of the defendant's wrongdoing if the wrongdoing ex ante created or enhanced the risk that caused the harm.[162]

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[155] *See, e.g.*, Holmes v. Sec. Inv. Prot. Corp., 503 U.S. 258, 268 (1992) (referring to proximate cause as a set of tools courts "[use] to limit a person's responsibility for the consequences of that person's own acts."); CSX Transp., Inc. v. McBride, 564 U.S. 685, 692 (2011) (describing proximate cause as "shorthand for a concept: Injuries have countless causes, and not all should give rise to legal liability."); Grady, *supra* note 52, at 315 n. 71 ("A liability-limiting doctrine, such as proximate cause, creates an impact only by barring liability."); KENNETH S. ABRAHAM, THE FORMS AND FUNCTIONS OF TORT LAW 124 (3d ed. 2007) ("[T]he doctrine of proximate cause operates as a limitation on the scope of the defendant's liability."); Sperino, *supra* note 66, at 1236 ("[P]roximate cause does not have a fixed meaning or goal, outside of a general principle of limiting liability.").

[156] Sandra F. Sperino, *Statutory Proximate Cause*, 88(3) NOTRE DAME L. REV. 1199, 1227 (2013) ("[T]he core concern of proximate cause is limiting liability.").

[157] Grady, *supra* note 52, at 315 n.71 ("A liability-limiting doctrine, such as proximate cause, creates an impact only by barring liability."). *See also* Sperino, *supra* note 156, ("[P]roximate cause does not have a fixed meaning or goal, outside of a general principle of limiting liability.")

[158] *See infra* Introduction.

[159] *See, e.g.*, Steckman et al., *supra* note 68, stating that:

> The policy behind loss causation is the same as that which underlies the concept of tort law proximate causation, namely avoidance of recovery of potentially unlimited damage claims that would contravene public policy and turn errant defendants into windfall guarantors. It does so by precluding recovery when injury was neither foreseeable nor a direct (causal) result of the challenged conduct.

[160] *See, e.g.*, Owen, *supra* note 51, at 1683; Grady, *supra* note 52, at 299.

[161] Grady, *supra* note 52, at 323 ("The basic test of the reasonable foresight doctrine is whether one can see a systematic relationship between the type of accident that the plaintiff suffered and the untaken precaution that constituted the defendant's breach of duty."); Benjamin C. Zipursky, *Foreseeability in Breach, Duty, and Proximate Cause*, 44 WAKE FOREST L. REV. 1247, 1271 (2009) ("[T]he plaintiff's injury must correlate with that aspect of the defendant's conduct that was negligent."). The "systematic relationship" requirement "bars liability for merely coincidental accidents." Grady, *supra* note 52, at 300.

[162] *See, e.g.*, Brackett v. Peters, 11 F.3d 78, 79 (7th Cir. 1993) (suggesting that conduct can qualify as the legal cause of a result if it made the result more likely); United States v. Hatfield, 591 F.3d 945, 948 (7th Cir. 2010) (stating that the test of proximate cause question is whether the defendants' conduct had "increase[d] the risk that this sort of mishap would occur"); KEETON ET AL., *supra* note 57, at 463–64, explaining that:

> [The essence of foreseeability is that] the scope of the defendant's liability is determined by the scope of the risk he negligently created . . . . When courts say that [] a risk is unforeseeable what they mean is that it is not a risk enhanced or created by the defendant's conduct."

Grady, *supra* note 52, at 323 (stating that a plaintiff must show that the untaken precaution would have reduced the risk of the accident at issue to prevail on proximate cause grounds); WILLIAM M.

A medical example provides a good illustration. Medical opinion is near unanimous that lung cancer is a foreseeable consequence of human exposure to tobacco smoke.[163] Clinical evidence shows that carcinogens in tobacco smoke interact with human DNA to cause genetic mutations that ultimately result in lung cancer.[164] The carcinogens and the disease-causing mechanisms they initiate define a *systematic relationship* between tobacco smoke and lung cancer that establishes the requisite foreseeability.

In a traditional tort case, the plaintiff must plead and prove that a *foreseeable* risk caused the plaintiff's harm.[165] A fraud-on-the-market plaintiff must show that a *foreseeable* corrective disclosure factually caused the stock price decline on which the plaintiff's loss causation and damages theories are predicated.[166] There must be a systematic relationship between the alleged fraud and the corrective disclosure. The following case provides an illustration.

LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 232, 237–39 (1987) ("From an economic standpoint, [a defendant's wrongdoing] "is not a cause" [of the plaintiff's harm if the wrongdoing] "did not increase the probability of an accident ex ante."); Robert G. Byrd, *Proximate Cause in North Carolina Tort Law*, 51 N.C. L. REV. 951, 958 (1973) ("Even when negligence is established, the question whether it created or increased the risk that caused injury remains.").

[163] *See, e.g.*, RUTH BONITA, ROBERT BEAGLEHOLE & TORD KJELLSTÖM, BASIC EPIDEMIOLOGY 9 (2d ed., 2006) ("It is now clear that the main cause of increasing lung cancer death rates is tobacco use."); BRUCE ALBERTS ET AL., ESSENTIAL CELL BIOLOGY 719 (3d ed., 2010) ("By far the most important environmental cause of cancer in the modern world . . . is tobacco-smoking, which is not only responsible for almost all cases of lung cancer but also raises the incidence of several other cancers . . . . ").

[164] *See, e.g.*, Stephen S. Hecht, *Cigarette Smoking and Lung Cancer: Chemical Mechanism and Approaches to Prevention* 3 J. THE LANCET 461, 461, (2002) ("Much is now known about the carcinogens in cigarette smoke, their conversion to forms that react with DNA, and the miscoding properties of the resulting DNA adducts that cause the many genetic changes known to exist in human lung cancer."); E. Brambilla & A. Gazdar, *Pathogenesis of Lung Cancer Signalling Pathways: Roadmap for Therapies*, 33 EUR. RESPIRATORY J. 1485, 1486 (2009) ("Among the 20 carcinogens that are present in tobacco smoke and strongly associated with lung cancer development, the best known are polycyclic aromatic hydrocarbons and nicotine-derived nitroso-aminoketone, which lead to genetic mutations through DNA adduct formation.").

[165] *See, e.g.*, Mark A. Geistfeld, *The Principle of Misalignment: Duty, Damages, and the Nature of Tort Liability*, 121 YALE L.J. 142, 153 (2011) ("[T]he imposition of liability requires proof that a foreseeable risk caused the plaintiff to suffer a compensable injury – the issue addressed by the element of proximate cause."); Kovach v. Caligor Midwest, 913 N.E.2d 193, 199 (Ind. 2009) (defendants were not held liable because wrongdoing alleged involved a risk different from the risk that factually caused plaintiff's injury.); RESTATEMENT (SECOND) OF TORTS § 548A cmt. a (AM. L. INST. 1977) ("In general, the misrepresentation is a legal cause only of those pecuniary losses that are within the foreseeable risk of harm that it creates.").

[166] *See, e.g.*, Nakkhumpun v. Taylor, 782 F.3d 1142, 1154 (10th Cir. 2015), describing the loss causation test:

> For loss causation under [a theory of materialization of a concealed risk], a plaintiff must allege two facts: (1) The risk that materialized was within the zone of risk concealed by the misrepresentation (foreseeability). (2) The materialization of the risk caused a negative impact on the value of the securities ([factual] causal link).

(citing Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005)); Ferrell, *supra* note 21, at 33 ("The identification of a 'corrective disclosure' is not only important as it is a necessary precondition to there being 'loss causation,' however, but also because the stock market reaction to such disclosures (controlling of course for contemporaneous market and industry conditions) will typically constitute the basis for plaintiffs' damage estimates."); *In re* Teco Energy, Inc. Sec. Litig., No. 8:04-CV-1948-T-27EAJ, 2006 WL 2884960, at *6 (M.D. Fla. Oct. 10, 2006) ("[E]vents such as suspended trading, announcement of write-offs, and issuance of revised earnings figures" can serve as corrective disclosures when they "were the material and foreseeable consequence of the defendants' omissions."); Rapp, *supra* note 110, at 434 ("Foreseeability plays a critical role in loss causation analysis based on the materialization of an undisclosed risk. Plaintiffs must demonstrate that materialization events were foreseeable consequences of the alleged fraud, and that these events revealed new information that effectively materialized the alleged concealed risk." (citing Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173–174 (2d Cir. 2005))).

In *Massey Energy Co. Sec. Litig.*,[167] a massive coal dust explosion at one of the mines of Massey Energy—the fourth largest coal producer in the United States and the largest coal producer in the Central Appalachian region—tore through the Upper Big Branch Mine owned by Massey Energy, killing twenty-nine miners and seriously injuring another.[168] The accident triggered a sharp decline in the price of Massey common stock.[169]

Within weeks of the explosion, Massey shareholders filed a claim under Section 10(b) and Rule 10b-5, alleging that false and misleading statements and omissions by the company about the safety of its mining operations and its regulatory compliance had inflated the price at which shareholders purchased Massey common stock, resulting in losses when a corrective event revealed the fraud and reset the artificial price.[170]

The court found that the plaintiffs had adequately pleaded loss causation. The mine explosion was "a disclosure event in starkest terms."[171] It revealed the defendant's fraud because it occurred due to materialization of the very risks that had been fraudulently concealed.[172] The reasonable foresight doctrine was clearly satisfied because there was a systematic relationship between fraudulent concealment of a risk and materialization of an event that reveals the concealed risk.

The defendant in a case such as *Massey* may rebut by showing violation of the direct consequences requirement—namely, that an intervening cause superseded and severed the causal link.[173] A creative defendant may also rebut the plaintiff's foreseeability argument. An analysis of the loss causation issue in event-driven cases has shown that loss causation does not exist, and the defendant escapes liability, if scientists could not ex ante predict the disclosure event (for instance, the coal dust explosion in *Massey*) that revealed the fraud and reset the inflated market price.[174]

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[167] *In re* Massey Energy Co. Sec. Litig., 883 F. Supp. 2d 597, 601 (S.D. W. Va. 2012).
[168] *Id.* at 605–06.
[169] *Id.* at 608.
[170] *Id.* at 625–26.
[171] Rapp, *supra* note 110, at 437 (citing *In re Massey*, 883 F. Supp. 2d at 626).
[172] The court found that the explosion had revealed the defendant's fraud because publicly available information had identified the cause of the explosion as the materialization of the very risks that had been fraudulently concealed*; see In re Massey*, 883 F. Supp. at 626*; see also* Rapp, *supra* note 110, at 432 ("An alternative approach to loss causation articulated by some courts looks to a disclosure event, or events, constituting the materialization of an undisclosed or misrepresented risk." (citing *In re* Williams Sec. Litig. – WCG Subclass, 558 F.3d 1130, 1142 (10th Cir. 2009))).
[173] *See, e.g.*, *In re* Micron Techs., Inc. Sec. Litig., 247 F.R.D. 627, 634–35 (Dist. Ct. Idaho 2007) (stating that defendant bears the burden to sever the link in the causal chain after plaintiffs show loss causation); Ferry Eden Lopez, *At a Loss with Loss Causation: Resolving the Ninth Circuit's Loss Causation Decisions in Metzler Investment GMBH v. Corinthian Colleges and* In re *Gilead Sciences*, 43 U.C. DAVIS L. REV. 1737, 1747–48 (2010) ("As with proximate cause, a defendant's proof of intervening causal factors establishes an affirmative defense to loss causation. Because of this, defendant corporations often contest the adequacy of a plaintiff's loss causation theory by moving to dismiss the Rule 10b-5 claim.") (citing *Dura*, 544 U.S. at 340, 342–43) *In re* Gilead Scis. Secs. Litig., 536 F.3d 1049, 1057–58 (9th Cir. 2008)); Tchr.'s Ret. Sys. of La., v. Hunter, 477 F.3d 162, 167 (4th Cir. 2007); Tricontinental Indus. v. Pricewaterhouse Coopers, L.L.P., 475 F.3d 824, 843 (7th Cir. 2007); Livid Holdings Ltd. v. Salomon Smith Barney, Inc., 416 F.3d 940, 949 (9th Cir. 2005).
[174] *See* de Villiers, *supra* note 70, at 447.

C. DIRECT CONSEQUENCES

The direct consequences doctrine of proximate cause examines concurrent efficient causes[175] of the plaintiff's harm to see whether an intervening cause has superseded the challenged conduct and cut off the defendant's liability.[176] The following example, based on *Derdiarian v. Felix Contracting*,[177] provides an illustration.

A construction company has its employees work in close proximity to busy traffic but does not provide adequate protective barriers around them. A passing motorist, an epileptic who neglected to take his anti-seizure medication, drives by and has a seizure. The motorist loses control and crashes his car into a worker on the site. The company's failure to provide reasonable safety measures and the motorist's negligence and subsequent medical event are all concurrent efficient causes of the worker's injury. The direct consequences doctrine examines the concurrent causes and determines whether an intervening cause is "significant enough" to cut off the liability of the construction company.[178]

As discussed earlier, the direct consequences doctrine denies liability in the superseding cause paradigm and the no corrective precaution paradigm.[179] This Section reviews the liability-limiting paradigms of the direct consequences doctrine and analyzes their role in securities fraud litigation.

1. Superseding Cause Paradigm

When an event, such as the medical event in the *Derdiarian* illustration, combines with prior wrongdoing to complete the chain of causation between the wrongdoing and a plaintiff's injury, the new event is called an *intervening cause*.[180] Not all intervening causes exempt the initial tortfeasor from liability.[181] The common law uses the term *superseding cause* to identify an

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[175] Grady, *supra* note 52, at 299 ("A single accident can have several causes in fact, each of which was necessary to produce the harm. This is the definition of concurrent efficient causes.").

[176] *Id.*

[177] Derdiarian v. Felix Contractor Corp., 51 N.Y.2d 308, 312 (1980).

[178] *See, e.g.*, RESTATEMENT (SECOND) OF TORTS, §441(1) (AM. L. INST. 1965) ("An intervening force is one which actively operates in producing harm to another after the actor's negligent act or omission has been committed.").

[179] *See infra* Introduction. *See also* Grady, *supra* note 52, at 315 n. 71 ("A liability-limiting doctrine, such as proximate cause, creates an impact only by barring liability. Only two direct consequences paradigms deny liability: [no corrective precaution] and [independent intervening tort].").

[180] *See, e.g.*, RESTATEMENT (SECOND) OF TORTS, § 441(1) (AM. L. INST. 1965) ("An intervening force is one which actively operates in producing harm to another after the actor's negligent act or omission has been committed."); KEETON ET AL., *supra* note 57, at 461 ("An intervening cause is a new cause that comes into play after the defendant's negligent conduct."); ERIC E. JOHNSON, TORTS: CASES AND CONTEXT 323–24 (1st ed. 2015) ("An intervening cause is some additional force or conduct that is necessary in order to complete the chain of causation between the breaching conduct and the injury. The intervening cause could be the actions of a third party, or it could be some natural event."). An intervening factor could be the wrongdoing of a party other than the plaintiff or defendant (intentional, reckless, or ordinary negligence); the non-faulty conduct of a third party; or a natural event. Israel Gilead & Michael D. Green, *Positive Externalities and the Economics of Proximate Cause*, 74 WASH. & LEE L. REV. 1517, 1560 (2017).

[181] VINCENT R. JOHNSON & ALAN GUNN, STUDIES IN AMERICAN TORT LAW 439 (4th ed. 2009) ("Not all intervening forces qualify as superseding causes."); Fisch, *supra* note 2, at 838 ("Under the common law, not all intervening events relieve a tortfeasor of liability." (citing Harrington v. Regina Med. Ctr., No. A03-1566, 2004 Minn. App. LEXIS 913, at *9 (Minn. Ct. App. July 26, 2004))); Weston Kowert, *The Foreseeability of Human–Artificial Intelligence Interactions*, 96 TEX. L. REV. 181, 188 (2017)

intervening cause that breaks the chain of causation and cuts off the defendant's liability for the ultimate harm.[182] The common law treatment of superseding causation has evolved over time.

Earlier courts held that unforeseeable intervening events are superseding causes, and foreseeable intervening events are not superseding causes.[183] Intentional and criminal intervening acts were considered unforeseeable as a matter of law and therefore treated as superseding causes.[184] The case of *Watson v. Kentucky & Indiana Bridge & Railroad Co.*,[185] illustrates the historical approach. In *Watson*, the defendant railroad company's gasoline tanker truck derailed and spilled a large quantity of gasoline into the surrounding area.[186] A bystander lit a match near the gasoline, causing it to ignite.[187] The resulting explosion injured the plaintiff and left his house in ruins.[188]

The case turned on whether the bystander lit the match merely to light a cigar and inadvertently ignited the gasoline, or did so with the intent to cause an explosion.[189] In the former situation, the bystander's inadvertent negligence would be a mere intervening cause and not a superseding cause; the defendant would remain liable for the plaintiff's injuries.[190] If, instead,

("[N]ot all intervening causes are created equal. Courts will not grant all intervening causes the status of a superseding cause.").

[182] *See, e.g.*, Owen, *supra* note 51, at 1684–85 ("If a jury or court concludes that . . . an 'intervening force' or cause was so significant that it 'breaks the chain' of proximate causation, the intervening cause of the third party is termed 'superseding' and the defendant is insulated from *all* responsibility for the harm."); Fisch, *supra* note 2, at 838 (citing Harrington v. Regina Med. Ctr., No. A03-1566, 2004 Minn. App. LEXIS 913, at *9 (Minn. Ct. App. July 26, 2004) ("Some courts use the term 'superseding cause' to identify an intervening event that is sufficient to break the causal chain.")); RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL & EMOTIONAL HARM § 34 (AM. L. INST. 2010).

[183] *See, e.g.*, Jim Gash, *At the Intersection of Proximate Cause and Terrorism: A Contextual Analysis of the (Proposed) Restatement Third of Torts' Approach to Intervening and Superseding Causes*, 91 KY. L.J. 523, 581–82 (2003).

[184] *See* DOBBS ET. AL., *supra* note 52, at 471 ("In an earlier era, courts tended to hold that intervening criminal acts were unforeseeable as a matter of law."); Crandall v. Consol. Tel., Tel. & Elec. Co., 127 P. 994, 997 (Ariz. 1912), the court explained:

> The criminal act of a third party can never be the natural sequence in the link of circumstances leading up to an injury, but, when such act is present, it must be considered as the efficient proximate cause of the subsequent injury, and the law will not go beyond it for a proximate cause.

Andrews v. Kinsel, 40 S.E. 300, 300 (Ga. 1901), the court described:

> It is also a well-recognized principle that where there has intervened between the defendant's negligent act and the injury an independent illegal act of a third person producing the injury, and without which it would not have happened, the latter is properly held the proximate cause of the injury, and the defendant is excused.

Laurence H. Eldredge, *Culpable Intervention as Superseding Cause*, 86 U. PA. L. REV. 121, 124 (1937) ("[T]he [historical] rule was that if after the defendant's wrongful conduct there intervened the wrongful (culpable) act of a third person, the latter relieved the defendant from liability, and 'the last human wrongdoer' was solely responsible for the plaintiff's harm."); Michael D. Green, *The Unanticipated Ripples of Comparative Negligence: Superseding Cause in Products Liability and Beyond*, 53 S.C. L. REV. 1103, 1113 (2002) ("Particularly when the intervening act was the product of intentionally tortious or criminal behavior, superseding cause doctrine prevented a negligent individual from bearing the entirety (or any) of the liability in which considerably more culpable conduct played a role.").

[185] Watson v. Ky. & Ind.Bridge & R.R. Co., 126 S.W. 146 (Ky. 1910).

[186] *Id.* at 147.

[187] *Id.*

[188] *Id.*

[189] *Id.* at 149.

[190] *Id.* at 150–51; *see also* Grady, *supra* note 52, at 312–13 (Defendant remains liable for foreseeably exposing plaintiff to harm due to inadvertent negligence of a third party).

the bystander had acted intentionally and maliciously, the railroad would not be liable because the criminal intervention of a third party would be a superseding cause as a matter of law.[191]

In the mid-twentieth century, courts reevaluated the presumption that intentional or criminal intervening acts are unforeseeable as a matter of law.[192] Modern courts simply ascertain whether an intervening event is foreseeable or unforeseeable.[193] If an intervening event is foreseeable—regardless of whether it is a criminal or intentional tortious act—the original wrongdoer's liability is preserved.[194] If the intervening event is not foreseeable, the event is deemed a superseding cause and the original

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[191] *Watson v. Ky. & Ind. Bridge. & R.R. Co.*, 126 S.W. at 151, the court explained:

> The mere fact that the concurrent cause or intervening act was unforeseen will not relieve the defendant guilty of the primary negligence from liability, but if the intervening agency is something so unexpected or extraordinary as that he could not or ought not to have anticipated it, he will not be liable and certainly he is not bound to anticipate the criminal acts of others by which damage is inflicted.

[192] *See, e.g.*, Britton v. Wooten, 817 S.W.2d 443, 449 (Ky. 1991) (describing an "archaic doctrine [that] has been rejected everywhere"); Largo Corp. v. Crespin, 727 P.2d 1098, 1103 (Colo. 1986) (rejecting the historical approach as "outdated and ill-reasoned" in favor of a modern rule that "[a]n intentionally tortious or criminal act of a third party does not break the causal chain if it is reasonably foreseeable").

[193] DOBBS ET AL., *supra* note 52, at 473 (Courts examine "the facts of particular cases to determine whether intervening criminal acts are foreseeable.").

[194] *See, e.g.*, Cusenbary v. Mortensen, 987 P.2d 351, 358 (Mont. 1999) (finding that driving drunk was a foreseeable intervening act which did not supersede original negligence of serving alcohol to visibly intoxicated individual); Washa v. Or. Dep't of Corrs., 979 P.2d 273, 283 (Or. Ct. App. 1999) (finding that the intervening acts of rape and murder were foreseeable in light of parolee's criminal history, preserving causal link with negligent defendant); Jutzi-Johnson v. United States, 263 F.3d 753, 756 (7th Cir. 2001), the court noted:

> [T]he doctrine of [superseding] cause is not applicable when the duty of care claimed to have been violated is precisely a duty to protect against ordinarily unforeseeable conduct. . . . and so a hospital that fails to maintain a careful watch over patients known to be suicidal is not excused by the doctrine of [superseding] cause from liability for a suicide, . . . any more than a zoo can escape liability for allowing a tiger to escape and maul people on the ground that the tiger is the [superseding] cause of the mauling.

Peter Zablotsky, *Mixing Oil and Water: Reconciling the Substantial Factor and Result-Within-the-Risk Approaches to Proximate Cause*, 56 CLEV. ST. L. REV. 1003, 1011 (2008) ("As evolved, the rule is that if the intervening act is itself a foreseeable aspect of the risk created by the original, negligent defendant, then the original defendant is not relieved of liability, i.e., is nonetheless the proximate cause of the ultimate injury."); Bandel v. Friedrich, 562 A.2d 813, 816 (N.J. Super. Ct. App. Div. 1989) ("A tortfeasor is answerable for the consequences of wrongful conduct despite the occurrence of an intervening cause of the harm so long as the intervening cause was foreseeable.").

wrongdoer escapes liability.[195] A leading Torts and Remedies treatise[196] states the modern rule: "A third party's criminal or intentional tortious conduct will not operate as a superseding cause to relieve the defendant of liability if the third party's conduct is a foreseeable result of the defendant's negligence."[197] This approach is the current majority rule.[198]

2. Corrective Disclosure as Intervening Event

In a fraud-on-the-market case, a corrective disclosure is an intervening event that combines with the defendant's fraud to complete the chain of causation between the defendant's fraud and the plaintiff's economic loss. A disclosure that is not systematically related to the alleged fraud does not count as a corrective disclosure for purposes of pleading and proving loss causation. It is a superseding event that severs the chain of causation and cuts off the defendant's liability for the claimed loss. The following hypothetical provides an illustration.

A company has two lines of business: software licensing and management consulting. The two divisions are legally separate and independently managed entities.[199] The accounting departments of both

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[195] *See, e.g.*, Robertson v. Sixpence Inns of Am., 789 P.2d 1040, 1047 (Ariz. 1990) ("A superseding cause, sufficient to become the proximate cause of the final result and relieve defendant of liability for his original negligence, arises only when an intervening force was unforeseeable and may be described, with the benefit of hindsight, as extraordinary."); Camp v. Loughran, 727 N.Y.S.2d 471, 473 (N.Y. App. Div. 2001) (finding sexual assault of a participant by other participants on a skiing outing was an unforeseeable act, severing proximate cause); Medcalf v. Wash. Heights Condo. Ass'n., 747 A.2d 532, 536 (Conn. App. Ct. 2000) (finding that assault of a person outside a building was an unforeseeable act arising from the failure to maintain the building's intercom system, cutting off liability of the defendant); Cope v. Enter. Rent-A-Car, 551 S.E.2d 841 (Ga. Ct. App. 2001) (finding assault upon truck renter whose truck broke down to be unforeseeable, severing the causal connection); DOBBS ET AL., *supra* note 52, at 444 ("[I]f a second person or a new force unforeseeably intervenes to trigger the plaintiff's injury after the defendant's act is complete, responsibility for the injury falls solely upon the second actor."); *id.* at 470–71 ("If an intervening and unforeseeable intentional harm or criminal act triggers the injury to the plaintiff, the criminal act is ordinarily called a superseding cause, with the result that the defendant who negligently creates the opportunity for such acts escapes liability."); W. PAGE KEETON, DAN B. DOBBS, ROBERT E. KEETON & DAVID G. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 44, at 303–04 (5th ed. 1984) ("Foreseeable intervening forces are within the scope of the original risk . . . . The courts are quite generally agreed that intervening causes which fall fairly in this category will not supersede the defendant's responsibility."). *But see* Michael K. Steenson, *Minnesota Negligence Law and the Restatement (Third) of Torts: Liability for Physical and Emotional Harms*, 37 WM. MITCHELL L. REV. 1055, 1073 (2011) ("The Third Restatement avoids the problem of foreseeability in intervening/superseding cause cases by simply folding the analysis into the scope of liability issue.") (citing RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL & EMOTIONAL HARM § 34 (2010)).

[196] J. HADLEY EDGAR, JR. & JAMES B. SALES, TEXAS TORTS AND REMEDIES (2015).

[197] *Id.* at § 1.04[4][d].

[198] RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL & EMOTIONAL HARM § 26 (AM. L. INST.), § (Tentative Draft No. 2, 2002) ("A strong majority of courts employ a foreseeability test for independent intervening acts that consist of culpable conduct by another."). *Accord* KEETON ET AL., *supra* note 57, at 472 ("Today's courts usually recognize that foreseeability, in the nature of things, is fact-specific, so they now often permit juries to find that a criminal act was foreseeable and not a superseding cause."); *id.* at 462, explaining:

> [I]n contemporary law, when courts then ask what counts as a superseding cause, they return to some form of the foreseeability inquiry. The rule is that if the intervening cause itself is part of the risk negligently created by the defendant, or if it is reasonably foreseeable at the time of the defendant's negligent conduct, then it is not a superseding cause at all.

[199] ROMAN WEIL, JENNIFER FRANCIS & KATHERINE SCHIPPER, FINANCIAL ACCOUNTING: AN INTRODUCTION TO CONCEPTS, METHODS, AND USES 767 (14th ed., 2014) ("[A division is a] more or less self-contained business that is part of a larger family of business units under common control. A division may be, but need not be, a separate legal entity."); *id.* at 555 ("Firms have several reasons for preferring to operate as a group of legally separate corporations (an affiliated group), rather than as a single entity.").

divisions prepare individual financial statements, which are then consolidated into the company's statements. The consolidated financial statements reflect the results that the company would report if it were a single economic entity.[200]

An accounting clerk in the software licensing division confidentially raises concerns with the Securities and Exchange Commission ("SEC") about the division's revenue recognition procedures.[201] Prompted by the whistleblower tip,[202] the SEC initiates a formal investigation and serves a subpoena on the company, requesting documents related to its accounting practices.[203] The company issues a press release notifying investors of the SEC subpoena and the fact that it will be investigated for improper revenue recognition. Its stock price promptly declines by twenty percent.

The SEC concludes its investigation of the software licensing division without finding any wrongdoing. The SEC then expands the scope of its investigation to the accounting practices of the management consulting division[204] and discovers that the division had inflated its earnings by recognizing revenue on fictitious transactions.[205] A week later, the company

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[200] *See, e.g.*, *id.* at 560.

[201] *Id.* at 146, 277, explaining:

> Revenue recognition involves decisions of both timing (when to recognize revenue) and measurement (the amount of revenue to recognize) . . . . [T]he two general conceptual criteria for revenue recognition are as follows: The seller must have substantially performed its obligations to the customer, for example, by transferring ownership of goods to the customer, and [t]he seller must have obtained an asset from the customer that it can reliably measure. If the asset is not cash, the seller must be reasonably certain of converting it into cash.

See also Stephen Errol Blythe, *Financial Statement Fraud: Lessons Learned from Selected U.S. Legal Cases in the Past Twenty Years*, 16 J. MOD. ACCT. & AUDITING. 1, 2 (2020).

[202] GEORGE E. GREER, SEC INVESTIGATIONS AND ENFORCEMENT ACTIONS: A PRACTICAL HANDBOOK FOR MUNICIPAL SECURITIES ISSUERS 12 (2011) ("SEC investigations may spring from any of a large number of different sources . . . . [T]ips by internal whistleblowers have prompted many investigations."). *See also* Broadwind Energy, Inc., Quarterly Report (Form 10-Q), at 13 (July 31, 2014) (referring to an SEC subpoena "issued following an informal inquiry that the Company received from the SEC . . . which likely arose out of a whistleblower complaint that the SEC received related to revenue recognition, cost accounting and intangible and fixed asset valuations at [the targeted company]"); United States v. Smith, 155 F.3d 1051, 1054 (9th Cir. 1998) (describing initiation of formal investigation following whistleblower's tip alleging insider trading).

[203] Madelyn la France, Jeffrey Boblick, Julia Dimitriadis, Jake Ducharme, Christina Fox, Joseph Lanuti, Daniel Villalba & Leah Wisser, *Securities Fraud*, 55 AM. CRIM. L. REV. 1677, 1738 (2018) ("Upon initiation of a formal investigation, the SEC may use its subpoena power to compel testimony and the production of evidence."). Federal securities laws authorize the SEC to issue subpoenas compelling documents and testimony under oath. *See* Securities Act of 1933 § 19(c), 15 U.S.C. § 77s(c); Securities Exchange Act of 1934 § 21(b), 15 U.S.C. § 78u(b); Advisers Act of 1940 § 209(b), 15 U.S.C. § 80b-9(b); Investment Company Act § 42(b), 15 U.S.C. § 80a-42(b)*; see also* United States v. Smith, 155 F.3d at 1054 (demonstrating use of SEC subpoena power to compel testimony and obtain documentary evidence).

[204] As an investigation evolves and new information comes to light, the SEC may expand the scope of its investigation. *See, e.g.*, SEC v. OKC Corp., 474 F. Supp. 1031, 1034 (N.D. Tex. 1979) ("It is well established that the scope of an administrative agency's investigatory power is broad.") (citing United States v. Morton Salt Co., 338 U.S. 632, 642 (1950)) (comparing an agency inquiry to that of a grand jury which can investigate without probable cause but "merely on suspicion that the law is being violated, or even just because it wants assurance that it is not"); ZVI BODIE, ALEX KANE & ALAN J. MARCUS., INVESTMENTS 83 (11th ed. 2018) ("[T]he SEC is the administrative agency responsible for broad oversight of the securities market."); Class Action Complaint at 10–11, Birnbaum v. Gen. Elec. Co., No. 19-cv-01013 (S.D.N.Y. 2019) ("Following our investor update . . . about the increase in future policy benefit reserves for GE Capital's run-off insurance operations, . . . the SEC staff expanded the scope of its investigation to encompass the reserve increase and the process leading to the reserve increase."); General Electric Company, Current Report (Form 8-K) (September 30, 2020).

[205] *See, e.g.*, DEAN C. BUNCH, KAREN M. CHEEK & DESI IVANOVA, *Financial Statement Investigations*, in LITIGATION SERVICES HANDBOOK: THE ROLE OF THE FINANCIAL EXPERT 17–18 (Roman L. Weil, Daniel G. Lentz & Elizabeth A. Evans eds., 6th ed. 2017) ("One of the most common

reveals the SEC's findings and announces that it will be restating its earnings from the first quarter of the current financial year as part of a settlement with the SEC.[206] The company's stock price shows no excess negative reaction to the announcement.[207]

Investors bring a securities fraud action against the company and its senior officers, alleging violation of Section 10(b) of the Exchange Act and Rule 10b-5. The plaintiffs allege that the company's stock price was artificially inflated by improper revenue recognition and that the disclosure of the SEC subpoena and investigation into revenue recognition practices by the company reset the inflated price when the stock price declined by twenty percent.[208] The plaintiffs predicate their loss causation theory on the SEC subpoena as a corrective disclosure of the company's improper revenue recognition.[209] The plaintiffs end the class period on the date that the company disclosed the subpoena and the price fell significantly, rather than the later date on which the company announced the restatement and the price showed no significant reaction.

Importantly, the SEC subpoena and investigation were revealed to the market during the class period, but the fraud alleged in the pleadings—improper revenue recognition—was revealed only after the class period had ended. This does not necessarily defeat the plaintiffs' claim. Under Ninth Circuit precedent, the market need not learn of and react to the actual fraud

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types of financial statement fraud is improper revenue recognition. For most firms, sooner is better when it comes to revenue. Accordingly, many schemes include fictitious revenue transactions or premature revenue recognition.").

[206] Companies under SEC investigation may agree to restate their financial statements as part of a settlement with the SEC, or do so in response to a direct order from the SEC. *See, e.g.*, Press Release, SEC, SEC Charges Time Warner with Fraud, Aiding and Abetting Frauds by Others, and Violating a Prior Cease-and-Desist Order; CFO, Controller, and Deputy Controller Charged with Causing Reporting Violations (March 21, 2005) (On file with SEC) (The Securities and Exchange Commission charged Time Warner Inc. with securities frauds, including materially overstating online advertising revenue and the number of its Internet subscribers. As part of its settlement with the SEC, Time Warner agreed to restate its historical financial results.); ROBERT W. KOLB, THE FINANCIAL CRISIS OF OUR TIME, 210–11 (2011) ("In 2004, the SEC found that Fannie Mae had violated accounting rules, with the result that earnings had been wildly overstated for the years 2001–2003. The SEC ordered a restatement of earnings for those years that wiped out a large portion of all reported profits.").

[207] "Excess return" is the component of the return on a stock that cannot be explained by general market and industry movements. It measures stock price reaction to firm-specific information, such as announcement of an SEC subpoena. Excess return is calculated by subtracting the expected return on a security from its actual return. *See, e.g.*, Jill E. Fisch, Jonah B. Gelbach & Jonathan Klick, *The Logic and Limits of Event Studies in Securities Fraud Litigation*, 96 TEX. L. REV. 553, 572 (2018).

[208] Courts accept negative market reaction to announcement of an SEC investigation as a predicate for loss causation. *See, e.g.*, *In re* Bradley Pharms., Inc. Sec. Litig., 421 F. Supp. 2d 822 (D.N.J. 2006); Ann M. Lipton, *Fact or Fiction: Flawed Approaches to Evaluating Market Behavior in Securities Litigation*, 20 TENN. J. BUS. L. 741, 759 n.85 (2019) explaining that in *Bradley*:

> . . . [The] court accepted loss causation allegations based on the announcement of an investigation . . . In that case, a company's stock price fell dramatically upon announcement of an informal SEC inquiry. At the conclusion of the investigation, the company was forced to restate previously reported sales, which resulted in a slight *uptick* in its stock price.

[209] Courts have accepted the announcement of a government investigation or subpoena as a corrective disclosure of fraudulent conduct. *E.g.*, Lloyd v. CVB Fin. Corp., 811 F.3d 1200, 1203 (9th Cir. 2016) ("[T]he announcement of an SEC investigation related to an alleged misrepresentation, coupled with a subsequent revelation of the inaccuracy of that misrepresentation, can serve as a corrective disclosure for the purpose of loss causation.") The Eleventh Circuit has taken a more restrictive view. *See* Meyer v. Greene, 710 F.3d 1189, 1195, 1201–02 (11th Cir. 2013) (stating that an investigation by the government merely "portend[s] an added *risk* of future corrective action" but does not "reveal to the market that a company's previous statements were false or fraudulent" and thus does not have a "*corrective* effect for purposes of loss causation").

itself during the class period. Plaintiffs may establish loss causation even if the fraud is revealed only after the end of the class period, provided plaintiffs can show at trial a systematic relationship between the alleged fraud (improper revenue recognition) and the corrective disclosure (SEC subpoena and investigation into improper revenue recognition).[210]

To summarize, in this hypothetical, the plaintiffs' loss causation theory is predicated on:

(1) improper revenue recognition in the company's financial statements;

(2) a corrective disclosure, namely a press release announcing an SEC subpoena and investigation into improper revenue recognition; and

(3) a twenty percent market price decline following the corrective disclosure. Prima facie, the reasonable foresight and directness requirements of loss causation appear satisfied. Upon closer scrutiny and analysis, however, neither is satisfied.

To establish reasonable foresight, the plaintiffs must show a systematic relationship between the corrective disclosure and the fraud specified in the pleadings. The corrective disclosure (the subpoena, and the investigation) resulted from a whistleblower tip-off based on alleged impropriety in the software licensing division of the company. The fraud alleged in the pleadings (improper revenue recognition) was perpetrated in the management consulting division and later incorporated into the company's consolidated financial statements. The two divisions are legally separate and independently managed entities. Therefore, there is no systematic relationship between accounting fraud in the management consulting division and an investigation triggered by an unrelated event in the software licensing division. There is no loss causation because the reasonable foresight test is not satisfied.

Similar reasoning shows that the direct consequences doctrine is also violated. Under the superseding cause paradigm, there is no loss causation if a factual cause of the stock price decline on which the plaintiff's loss causation theory is predicated is not systematically related to the challenged conduct. In this case, the announcement of an SEC subpoena and investigation—a factual cause of the twenty percent price decline—is independent of the alleged fraud. It is, therefore, a superseding cause of the stock price decline on which the plaintiffs' loss causation theory is predicated.

In conclusion, the plaintiffs' Rule 10b-5 action would likely fail. There is no loss causation, because the plaintiffs' claimed loss was neither directly

[210] *See, e.g.*, *Mineworkers' Pension Scheme*, 881 F.3d at 751. The Third Circuit has taken a similar position. *See also McCabe*, 494 F.3d 418, 431 (3d Cir. 2007) (a plaintiff need only trace the loss back to "the very facts about which the defendant lied," regardless of what the market knew (quoting Caremark, Inc. v. Coram Healthcare Corp., 113 F.3d 645, 648 (7th Cir. 1997))); *Gallup*, 489 F. App'x at 556 (3d Cir. 2012).

caused by the challenged conduct nor a reasonably foreseeable result of it, despite prima facie appearances to the contrary.

3. No Corrective Precaution Paradigm

The no corrective precaution paradigm of the direct consequences doctrine allows a wrongdoer (who creates a risky situation) to escape liability when an intervening person, who has a duty and opportunity to take a precaution against the risk that threatens the plaintiff, nevertheless recklessly or intentionally fails to take necessary action. In this paradigm, the wrongdoer escapes liability, and the intervening person becomes solely liable for failing to prevent the accident.

For example, in *Sinram v. Pennsylvania Railroad Co*., the defendant's tugboat collided with a barge.[211] The captain of the barge was aware of the collision but chose not to inspect the barge for seaworthiness before loading coal onto the damaged vessel.[212] The barge then sank, and the cargo of coal was lost.[213] The issue before the court was whether the loss was proximately caused by the defendant railroad whose negligence had caused the initial collision.[214] The barge captain had the duty and opportunity to inspect the barge for seaworthiness and take precautions to avoid the sinking and loss of the coal, but willfully failed to do so.[215] The defendant tug operator, therefore, escaped liability for the sinking of the barge and the loss of the coal under the no corrective precaution paradigm.[216]

Translated into a securities fraud context, the no corrective precaution paradigm provides that a defendant whose fraud exposed a plaintiff to risk of economic loss will not be liable for that part of the plaintiff's loss caused by the plaintiff's own failure to preserve her investment when she first learned of the fraud or had reason to know of it. *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[217] a fraud-on-the-market case, illustrates the paradigm.

In *Arrington*, the plaintiffs, Clyde and Joy Arrington, opened a brokerage account with the defendant, Merrill Lynch, and invested $280,000 in Western Airlines securities.[218] On the advice of their Merrill Lynch stockbroker, the Arringtons opened a margin account and purchased securities on margin.[219] An investor who uses margin buys securities with a combination of her own funds and money borrowed from a broker.[220] The investor has equity in the

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[211] Sinram v. Pennsylvania R.R. Co., 61 F. 2d 767, 768 (2d Cir. 1932); *see also* Dominices v. Monongahela Connecting R.R. Co., 195 A. 747, 748 (Pa. 1937), holding:

> Where a consignee, with full knowledge of the existence of a condition in a freight car which makes its unloading dangerous to the consignee's employees, orders his employees to proceed with the unloading without warning them of the known defect, such conduct of the consignee is unforeseeable, and constitute a superseding cause, which relieves the railroad company from liability for its prior negligence.

[212] *Sinram*, 61 F.2d at 768.
[213] *Id.*
[214] *Id.* at 771.
[215] *Id*. at 769.
[216] *Id.*
[217] Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615 (9th Cir. 1981).
[218] *Id.* at 618.
[219] *Id.*
[220] *Id.*

investment equal to the market value of the securities minus the value of the borrowed funds.[221] A margin call is triggered when the investor's equity falls below a certain requirement, called the maintenance margin. The margin call requires the investor to top up her account to meet the maintenance margin. If the margin call is not met in a timely manner, the broker may liquidate securities to bring the account into compliance with the margin rules. The broker does not need the investor's approval to do this and the investor is responsible for any losses sustained in the process.[222]

The leverage inherent in margin financing multiplies the risk of an investment by amplifying the investment's response to economic events.[223] It creates the possibility of large gains, but also large losses in a declining market when the investor has to repay the margin loan in addition to suffering investment losses.[224] The high risk and speculative nature of margin accounts make them improper investment vehicles for trustees and other fiduciaries.[225] The Arringtons' Merrill Lynch account executive failed to inform his clients about the multiplier effect margin financing has on an investor's losses in a declining market.[226] When the Arringtons suffered substantial losses in the stock market crash of 1974, they filed suit against the account executive and brokerage firm, alleging violations of federal securities laws.[227] The trial court found that the account executive had induced the Arringtons to open a margin account without adequately informing them of the risks inherent in margin financing.[228] The court also found, however, that the causal chain of damages was broken when the Arringtons received their first margin maintenance call.[229] At that point, the risks of margin financing became apparent to the Arringtons, and they had the opportunity to avoid further

[221] *Id.*

[222] *See, e.g.*, JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES 28–29, 205–06, (8th ed., 2012); BLACK'S LAW DICTIONARY 610 (8th ed., 2004) (defining "margin call"); Zvi Bodie, Alan Alex & Marcus Kane, INVESTMENTS 77–79 (12th ed., 2021).

[223] *Id.* at 620 (referring to "the multiplier effect margin financing has on a trader's losses in a declining market."); Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721, 768 (1976) ("The use of borrowed funds intensifies a portfolio's reaction to events, and for that reason, leveraging has always been viewed as the tool of the speculator, intent on obtaining large gains at the risk of substantial loss.").

[224] *See, e.g.*, Zvi Bodie, Alan Alex & Marcus Kane, INVESTMENTS 77–79 (12th ed., 2021).

[225] *See, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocock, 247 F. Supp. 373, 379 (S.D. Tex. 1965) (holding that "[a] margin account and a short sale are speculative to the extent that they can be termed 'rank gambles' "); RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. f (AM. L. INST. 2012) (stating that the purchase of stocks on margin is an improper trust investment practice); BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 91 (1986) ("Leverage is equated with excessive risk that is speculative and, therefore, forbidden."); AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, SCOTT ON TRUSTS: THE LAW OF TRUSTS § 227.6, at 444 (4th ed. 1988) (stating it is clear that trustees cannot purchase securities on margin); Michael T. Johnson, *Speculating on the Efficacy of "Speculation": An Analysis of the Prudent Person's Slipperiest Term of Art in Light of Modern Portfolio Theory*, 48 STAN. L. REV. 419, 440 (1996) (citing RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. f. (AM. L. INST. 1957) ("Unless it is otherwise provided by the terms of the trust, the following are not proper trust investments: (1) purchase of securities for purposes of speculation, for example, purchase of shares of stock on margin . . . .")).

[226] *Arrington*, 651 F.2d at 620.

[227] *Id.* at 619.

[228] *Id.* at 618 ("[Merrill Lynch Account Executive] Richie misrepresented to Arrington the risks of purchasing stocks on margin, the recommendations of Merrill Lynch analysts regarding the four stocks he was pushing, and the increased risks of large margin accounts in the market decline he knew was occurring.").

[229] *Id.* at 619.

losses by selling their margined stock.[230] The trial court accordingly based the damages award on the loss they would have suffered if they had sold their margined investments when they received their first margin call.[231] The Ninth Circuit affirmed the district court's damages theory, namely that the Arringtons "cannot recover that part of their loss caused by their own failure, once they had reason to know of the wrongdoing, to take reasonable steps to avoid further harm."[232]

The Arringtons had both the duty and opportunity to preserve their investment when they first learned of the fraud or had reason to know of it. The duty is rooted in the common law duty of a plaintiff to take reasonable steps to mitigate damages.[233] The duty to mitigate applies generally in commercial litigation,[234] mostly in claims arising in tort and contract,[235] but courts have also applied the doctrine to claims in securities fraud.[236]

The Arringtons also had the opportunity to mitigate. They learned of the risks that had previously been concealed from them when they received the margin calls and were advised to "either put up money or sell some stock in a three-to-one ratio to maintain the account."[237] The mitigating options explicitly presented to them would have prevented further losses. Under the no corrective precaution paradigm, the defendants were not liable for losses that the plaintiffs had both the duty and opportunity to avoid.

Rule 10b-5 defendants may achieve the same liability-limiting result by pleading "failure to mitigate damages" rather than explicitly relying on loss

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[230] *Id.* at 620 ("[Defendant stockbroker] failed to tell Arrington about the multiplier effect margin financing has on a trader's losses in a declining market. There is nothing in the record before us to indicate that Arrington became aware of this fact before Merrill Lynch sent the Arringtons their first margin maintenance call.").

[231] *Id.* at 621.

[232] *Id.* at 619 ("[P]laintiffs had *broken the chain of causation of their damages* by not selling their margined stocks . . . when they knew or should have known of the fraud committed by [defendant stockbroker].") (emphasis added); *Id.* at 622 ("Plaintiffs' proposed damage formula would allow them to recover for the losses they suffered as a result of the market decline in their Western Airlines stock. They have shown *no causal connection* between defendants' fraud and this decline.") (emphasis added).

[233] *See, e.g.*, Ford Motor Co. v. EEOC, 458 U.S. 219, 232 n.15 (1982), the court stated:

> Where one person has committed a tort, breach of contract, or other legal wrong against another it is incumbent upon the latter to use such means as are reasonable under the circumstances to avoid or minimize the damages. The person wronged cannot recover for any item of damage which could thus have been avoided.

(quoting C. MCCORMICK, LAW OF DAMAGES 127–58 (1935)); BCC ADVISERS, *Mitigating Circumstances Reasonable Damages and the Plaintiff's Duty*, *in* LITIGATION & VALUATION REPORT at 4, (Sept.–Oct. 2008).

[234] *See, e.g.*, S.J. Groves & Sons Co. v. Warner Co., 576 F.2d 524 (3d Cir. 1978) (holding that the duty to mitigate is a tool to limit a plaintiff's recovery); Mark A. Allen, Robert E. Hall & Victoria A. Lazear, *Reference Guide on Estimation of Economic Damages*, *in* REFERENCE MANUAL ON SCIENTIFIC EVIDENCE 425, 461 (3d ed. 2011) (stating that the law imposes a duty to mitigate its damages as an "important [limitation] on a plaintiff's ability to recover losses as damages").

[235] *See, e.g.*, Ford Motor Co. v. EEOC, 458 U.S. at 232 n.15; Stimpson Hosiery Mills, Inc. v. Pam Trading Corp*.*, S.E.2d 128, 132 (N.C. 1990), *review denied*, 393 S.E.2d 909 (N.C. 1990) ("The doctrine of avoidable consequences or the duty to minimize damages requires that 'an injured plaintiff, whether [its] case be tort or contract, must exercise reasonable care and diligence to avoid or lessen the *consequences* of the defendant[s'] wrong.' ").

[236] *See, e.g.*, Foster v. Fin. Tech. Inc., 517 F.2d 1068, 1072 (9th Cir. 1975) ("Under the familiar mitigation of damages principle, a party cannot recover that part of his loss caused by his own failure, once he has reason to know of the breach, to take reasonable steps to avoid further harm."); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 428 (N.D. Cal. 1968), *aff'd on other grounds*, 430 F.2d 1202, 1207 (9th Cir. 1970) ("The purpose of [the securities laws] is to protect the innocent investor, as distinguished from one who loses his innocence and waits to see how his investment turns out.").

[237] *Arrington*, 651 F.2d at 618.

causation arguments. However, defendants may prefer to prove the absence of loss causation, thereby defeating a 10b-5 claim directly by discrediting a key 10b-5 element.[238]

CONCLUSION

The PSLRA[239] codified the loss causation element of a private securities fraud action, providing that a plaintiff must prove that the defendant's fraud "caused the loss for which the plaintiff seeks to recover damages."[240] In *Dura*, the U.S. Supreme Court counseled lower courts to interpret loss causation in accordance with common law tort principles, but did not specify how the principles apply in a fraud-on-the-market context. The minimalist instruction has led lower courts to issue "confusing and inconsistent decisions," often disconnected from common law tort principles.

This Article develops an interpretation of loss causation as a translation of the common law tort doctrines of factual and proximate cause into a fraud-on-the-market context that preserves their core policy goals. The interpretation identifies the relations between the defendant's fraud, a corrective disclosure, and the plaintiff's economic loss that must be pleaded and proven to establish loss causation.

Influential commentators have criticized the *Dura Pharmaceuticals* model of causation and, by implication, its interpretation in this Article. Professors Merritt Fox and Joshua Mitts argue that, contrary to *Dura*, there are circumstances under which a defrauded plaintiff should be allowed to recover for losses even if caused by an independent intervening event.[241] They provide the following illustrative example:

> The classic example of where [the] language [of the Dura model] might come into play would be where a plaintiff purchases an issuer's stock shortly after it substantially misstates its earnings, thereby creating the impression that the company's future cash flows will be higher than the correct number would suggest and inflating its share price. Subsequently the issuer's only factory burns down putting it out of business. At the time of the fire, the market has no idea about the falsity of its earnings statement, but thereafter there is an announcement revealing what the true situation had been at the time of the misstatement. The [Dura] Court's language could be interpreted as saying that the loss the plaintiff suffered was due to an intervening cause, the fire, and hence it is not actionable. The price change accompanying the corrective disclosure would be zero. This is not the correct way to look at the situation, however. The plaintiff is as unable to recover her overpayment as she would have been had there been an

[238] *See, e.g.*, Stern, *supra* note 70, at 11 ("Proof of loss causation is an essential element of a Rule 10b-5 private securities fraud action, and the *absence* of loss causation is an affirmative defense under §11 and §12 of the Securities Act of 1933.").

[239] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 21D(b)(4), 109 Stat. 737, 747 (codified at 15 U.S.C. § 78u-4(b)(4) (2006)).

[240] 15 U.S.C. § 78u-4(b)(4).

[241] Fox & Mitts, *supra* note 19, at 11 n.22, 65.

> announcement of the truth but no fire. . . . [T]he fire [is not] an intervening cause that [breaks the causal chain].[242]

Their logic is compelling, but it violates fidelity in translation. A faithful translation of proximate cause into a fraud-on-the-market context must preserve its policy goals as a liability-limiting mechanism. The mechanism is implemented by the reasonable foresight doctrine and the direct consequences doctrine. Under the superseding cause paradigm of the direct consequences doctrine, there is no loss causation if a factual cause of the stock price decline on which the plaintiff's loss causation and damages theories are predicated is not systematically related to the challenged conduct. The fire in the example is a factual cause of the plaintiff's loss. It is, however, not a proximate cause of the loss. There is no systematic relationship between a corporation's earnings misstatement and a natural disaster such as a wildfire. Under the *Dura* model and its interpretation developed in this Article, the fire supersedes the defendant's fraud, and there is no loss causation.

Denying a defrauded plaintiff recovery because an intervening cause preceded revelation of the fraud, rather than vice versa, may appear arbitrary and in violation of the compensatory function of civil liability.[243] However, civil liability also has a liability-limiting function. It imposes reasonable limits on a defendant's liability by requiring not only factual cause, but also proximate cause. A faithful translation of the Supreme Court's mandate must preserve the liability-limiting function of proximate cause in a fraud-on-the-market context. This means Rule 10b-5 liability must be denied for losses caused by an independent intervening event.

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[242] *Id.* at 65.

[243] *See, e.g.*, Steve Boccara, *Medical Malpractice*, *in* TORT LAW AND ECONOMICS, 345 (Michael Faure ed. 2009) (referring to "the two main functions of civil liability: the deterrent function and the compensatory function." The Ninth Circuit has described the out-of-pocket measure of damages for Rule 10b-5 violations as "purely compensatory"). DCD Programs, Ltd. v. Leighton, 90 F.3d 1442, 1447 (9th Cir. 1996) ("[The out-of-pocket] measure of damages is purely compensatory, and it focuses on the plaintiff's actual loss, rather than on his potential gain."). *See also* Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 885 (1990) ("The most common method of calculating damages in Rule 10b-5 cases is the out-of-pocket measure.").