



# SECURITIES REGULATION & LAW



## REPORT

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### Jurisdiction and Procedure

## Clarifying Loss Causation: Reconciling the 'Zone of Risk' Test With *Dura Pharmaceuticals*

By ANDREW J. MORRIS AND LUCIUS OUTLAW

**D***ura Pharmaceuticals, Inc. v. Broudo* focuses the loss causation question firmly on the reason for the decline in stock price. It requires that securities fraud plaintiffs identify a disclosure of the “relevant truth” and a resulting decline in stock price.<sup>1</sup> 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. As a result, some courts have given this requirement a decidedly relaxed reading. In particular, they have permitted almost any bad news that causes stock prices to decline to count as the “relevant truth.” As this article explains, this relaxed approach permits plaintiffs to establish loss causation

<sup>1</sup> 544 U.S. 336 (2005). Loss causation is an element of Section 10(b) claims under the Exchange Act. 15 U.S.C. § 78u-4(b)(4); see also *In re Salomon Smith Barney Mut. Fund Fees Litig.*, 441 F. Supp. 2d 579, 588 (S.D.N.Y. 2006) (“Loss causation is an element in Plaintiffs’ Section 10(b) claim under the Exchange Act.”). It is also an affirmative defense to a claim under Section 12 of the Securities Act of 1933, 15 U.S.C. 77l(b), and to claims under Section 11 of the 1933 Act. 15 U.S.C. § 77k(e).

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based solely on *inflation* in stock price—exactly the position that *Dura* rejected.

Consider a common fact pattern. A company materially overstates revenue. While this misstatement remains hidden, the company discloses some financial setback, such as a missed earnings target, and its stock price falls. Later the company discloses that it had overstated its revenue.<sup>2</sup> Does the disclosure of the financial setback count as a revelation of the “relevant truth,” because it revealed that the company’s financial position was weaker than the company had previously indicated? Or does the “relevant truth” rule require specific disclosure that the earlier earnings figures were overstated? Especially in light of the frequency of restatements and earnings misses, getting the answer right is important.

*Dura* does not give an explicit answer, but it does provide considerable guidance. The first part of this article reviews some of that guidance. The second part discusses an approach courts have used to identify the “relevant truth”—the “zone of risk” test or same “subject” test. This part identifies two approaches in the courts, applying narrower and broader forms of that test. The third part explains that the broader form of the

<sup>2</sup> In this article, we abstract somewhat from the details of the cases in order to draw some general conclusions about the direction of the law, understanding that loss causation is often quite nuanced and can turn on the fine points of each misstatement and each disclosure.

test conflicts with *Dura*, effectively nullifying the Supreme Court's holding. It explains why the "zone of risk" or "subject" approach must be carefully limited if it is to advance *Dura*'s emphasis on connecting the misstatement with the plaintiffs' loss. Part four then explains how the "zone of risk" or "subject" approach should be brought in line with *Dura*.

### 1. Acknowledging the Full Meaning of *Dura*

In *Dura*, the United States Supreme Court held that plaintiffs could not satisfy the loss causation requirement for securities fraud by showing only that a misstatement had inflated the stock price.<sup>3</sup> Rather, the Court held, plaintiffs must show that the "relevant truth" came out, did so before the relevant price decline, and "proximately caused" the plaintiffs' loss.<sup>4</sup> The Court specifically equated the "relevant truth" with the defendant's "misrepresentation."<sup>5</sup> Therefore, the Court stated, a plaintiff must identify "what the causal connection might be between the loss and the misrepresentation."<sup>6</sup>

The Court did not say how closely the disclosure that causes the price decline must match the earlier misrepresentation to count as disclosure of the "relevant truth."<sup>7</sup> Courts interpreting *Dura* often seem to assume that the opinion provides no further guidance on this critical point. They tend to cite general language from *Dura* as a stepping-off point, without looking further for other direction from the case.<sup>8</sup>

This sells *Dura* woefully short. *Dura* provides guidance that extends well beyond the letter of its holding. The Court explained its holding at some length. In particular, the Court emphasized the distinctness of the loss causation requirement, and placed that requirement squarely in the tradition of proximate cause law and scholarship.

For example, the Court twice noted that the loss causation requirement, contained in the Securities Exchange Act, is distinct from other elements of securities fraud.<sup>9</sup> The Court specifically rejected the position of the U.S. Court of Appeals for the Ninth Circuit that it suffices if the misrepresentation even "touches upon" a later economic loss.<sup>10</sup> As the Court explained, making that vague association of misrepresentation and loss is

<sup>3</sup> 544 U.S. at 344-45.

<sup>4</sup> 544 U.S. at 342-46; *see id.* at 343 ("Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will sometimes play a role in bringing about a future loss. It may prove to be a necessary condition of any such loss, and in that sense one might say that the inflated purchase price suggests that the misrepresentation . . . 'touches upon' a later economic loss. . . . But, even if that is so, it is insufficient. To 'touch upon' a loss is not to cause a loss, and it is the latter that the law requires.") (emphasis in original; internal citations omitted).

<sup>5</sup> *Id.* at 342. The relevant sentence states, "But if, say the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss." *Id.*

<sup>6</sup> *Id.* at 347.

<sup>7</sup> *Dura* was an easy case on this point, because there was no dispute that the "relevant truth" was the disclosure that the FDA would not approve the company's asthmatic spray device, despite the company's earlier representation that the agency would. 544 U.S. at 339.

<sup>8</sup> A typical example is *In re Enron Corp. Sec. Litig.*, 439 F. Supp. 2d 692, 700-01 (S.D. Tex. 2006).

<sup>9</sup> 544 U.S. at 339, 345-46.

<sup>10</sup> *Id.* at 343.

not the same as saying that the misrepresentation is the "cause" of a loss.<sup>11</sup> The emphasis on "cause" is the Court's. The "touches upon" connection, the Court explained, says only that a misrepresentation is a "necessary condition" for a loss<sup>12</sup> it is mere "but-for" causation.

The Court next explained, in some detail, the loss-causation requirement's deep roots in the common law of proximate cause.<sup>13</sup> The Court cited the *Restatement (Second) of Torts*, five different treatises, and several common law cases—starting with an English case from more than 200 years ago. The Court explained how each of these sources stated the importance of connecting the "deceit" and the loss.<sup>14</sup> For example, it quoted the *Restatement (Second) of Torts* as setting out the "judicial consensus" that "a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains 'when the facts . . . become generally known' and 'as a result' share value depreciate[s]."<sup>15</sup> The Court also quoted a discussion of but-for causation from *Prosser and Keeton on the Law of Torts*, that plaintiffs should not recover for losses "brought about by business conditions or other factors."<sup>16</sup> The Court also expressed its approval of the law in the federal circuits that rejected the Ninth Circuit's lower standard for proving loss causation.<sup>17</sup>

By now it was impossible to miss the point, but the Court went on to remind the plaintiffs that the role of "the securities statutes" is "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that *misrepresentations* actually cause."<sup>18</sup> The Court also cited *Bastian v. Petren Resources Corp.*, which articulates the loss-within-the-risk requirement.<sup>19</sup> That requirement confirms that, for purposes of proximate cause, the disclosure, or the relevant risk, must have to do with the reason the earlier statement was false.<sup>20</sup>

## 2. Determining Whether 'the Truth Became Known' and Was the 'Proximate Cause' of the Loss

### A. The 'Zone of Risk' Test

Courts have identified two primary ways plaintiffs can show that the "relevant truth" came out at the time of the loss.<sup>21</sup> One is to show that the disclosure made at the time of the price decline was plainly "corrective" of an earlier misstatement.<sup>22</sup> The alternative is the "zone

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 345.

<sup>14</sup> *Id.* at 343-44.

<sup>15</sup> *Id.* at 344 (quoting *Restatement (Second) of Torts* § 548A cmt. b at 107 (1976) (ellipsis and alteration in original)).

<sup>16</sup> 544 U.S. at 344-45 (quoting W. Page Keeton et al., *Prosser and Keeton on the Law of Torts* § 110, at 767 (5th ed. 1984)).

<sup>17</sup> *Id.* at 344.

<sup>18</sup> *Id.* at 345 (emphasis added; citation omitted).

<sup>19</sup> 892 F.2d 680, 685 (7th Cir. 1990).

<sup>20</sup> *Id.* at 685.

<sup>21</sup> These are distinct in concept if not always in application. For an example of a case that clearly distinguishes between the two, see *Leykin v. AT&T Corp.*, 423 F. Supp. 2d 229, 243-43 (S.D.N.Y. 2006).

<sup>22</sup> As one court explained, loss causation post-*Dura* "is less concerned with the misrepresentation that fooled the victim into the transaction, and more with whether it was the concealed or misrepresented fact which caused the harm." *Id.* at 239. *See also In re Tellium Inc. Sec. Litig.*, 2005 WL 2090254,

of risk” or same “subject” approach, which is available for cases in which plaintiffs cannot identify a corrective disclosure at the time of the price decline.<sup>23</sup> This alternative usually is traced to the Second Circuit’s holding in *Lentell*.<sup>24</sup> The *Lentell* court explained that “it cannot ordinarily be said that a drop in the value of a security is ‘caused’ by the misstatements or omissions about it, as opposed to the *underlying circumstance* that is concealed or misstated.”<sup>25</sup> “Put another way,” the question is whether “the loss was within the *zone of the risk* concealed by the misrepresentations or omissions.”<sup>26</sup> Loss causation is established, therefore, where “the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered.”<sup>27</sup> At the time the court issued the decision, *Lentell* appeared to tighten the loss causation requirement by rejecting a complaint that failed to “grapple in any meaningful way with the complexity” of the relationship between alleged misconduct and stock price movements or to “account for the price volatility risk inherent in the stocks.”<sup>28</sup>

#### **B. *Dura* With Bite: A Narrow Reading of the Zone of Risk or Subject Matter Test**

Applying these standards to the fact pattern described above—misstatement, stock decline upon disclosure of some financial setback, post-decline correction of the misstatement—post-*Dura* courts have dismissed a host of complaints.<sup>29</sup> One example is *Davidoff*

at \*4 (D.N.J. Aug. 26, 2005) (“Plaintiffs must allege that at some point, the concealed scheme was disclosed to the market, because ‘[w]here the alleged misstatement conceals a condition or event which then occurs and causes the plaintiff’s loss, it is the materialization of the undisclosed condition or event that causes the loss.’”). See also *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 175 n.4 (2d Cir. 2005).

<sup>23</sup> See, e.g., *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier*, 2005 WL 2148919, at \*12 (S.D.N.Y. Sept. 6, 2005); *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278, 305-06 (S.D.N.Y. 2005).

<sup>24</sup> 396 F.3d at 173. The *Lentell* decision was not issued until after *Dura* had been argued in the Supreme Court, but *Dura* cited with approval the Second Circuit loss causation standard, *Dura*, 544 U.S. at 340, 344 (citing *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003)) pointing to the same case on which *Lentell* also relied. *Lentell*, 396 F.3d at 172-73.

<sup>25</sup> 396 F.3d at 173 (emphasis in original).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* (emphasis in original; citation omitted).

<sup>28</sup> *Id.* at 176. See also *id.* at 173 (referring to “the underlying circumstance that is concealed or misstated” and discussing whether “the subject of the fraudulent statement or omission was the cause of the actual loss suffered” and whether “the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security”).

<sup>29</sup> Other courts have dismissed complaints that were based on the same fact pattern. See, e.g., *In re First Union Corp. Sec. Litig.*, 2006 WL 163616 (W.D.N.C. Jan. 20, 2006) (truth about alleged fraud was not disclosed until after the company had revised earnings estimates and stock price had fallen); *D.E. & L.J. P’ship v. Conaway*, 133 F. App’x 994, 998-99 (6th Cir. 2005) (alleging accounting fraud through false reporting of rebates and other misstatements); *Payne v. DeLuca*, 433 F. Supp. 2d 547, 610 (W.D. Pa. 2006) (“none of the statements [relied on by plaintiffs], satisfies the cause-and-effect requirements of *Dura* because none of them discloses the alleged fraudulent scheme which purportedly caused the price of ITG stock to be inflated in the first place”); *In re The Warnaco Group, Inc. Sec. Litig. II*, 388 F. Supp. 2d 307, 318 (S.D.N.Y. 2005) (under “risk” test, holding that loss causation not al-

leged where plaintiff contended “if the true subscriber growth and prospects had been as represented, [the company] would have had more financial strength and would not have had to file for bankruptcy as it did”; i.e., misstatement of subscriber figures allegedly caused later liquidity crisis, because the assertion is too general and conclusory); *In re Compuware Sec. Litig.*, 386 F. Supp. 2d 913, 918-19 (E.D. Mich. 2005) (where misstatement was failure to disclose problem with an important customer relationship, court found that there was no loss causation connection with a stock price drop due to announced revenue shortfall). In *In re Cree, Inc. Sec. Litig.*, 2005 WL 1847004, at \*2 (M.D.N.C. Aug. 2, 2005), the plaintiffs alleged certain fraudulent accounting and other federal securities law violations. The company then was sued by one of its officers, causing its stock to drop. *Id.* at \*1. The accounting fraud was not disclosed until later. Because the lawsuit that caused the stock to drop did not reveal the accounting fraud, plaintiffs had failed to allege loss causation. *Id.* at \*12-13. The same is true of *Acterna Corp. Sec. Litig.*, 378 F. Supp. 2d 561 (D. Md. 2005). There the defendant company allegedly misled the market about its financial condition by failing to take required and material impairment charges. *Id.* at 566-68. After its stock fell due to disclosures of losses and weak sales, the company took the required, but overdue, impairment charges. *Id.* at 568. The plaintiffs did not establish loss causation because there was no indication that the impairment charges bore any relation to the earlier drop. *Id.* at 584-89.

<sup>30</sup> 2005 WL 2030501 (S.D.N.Y. Aug. 22, 2005).

<sup>31</sup> *Id.* at \*5-6, \*14-15.

<sup>32</sup> *Id.* at \*3.

<sup>33</sup> *Id.* at \*15-16.

<sup>34</sup> *Id.* at \*16.

<sup>35</sup> *Id.* at \*15. The court did not use the term “zone of risk” but cited that authority and referring to the same “subject” requirement. *Id.* (quoting *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001)).

<sup>36</sup> 423 F. Supp. 2d at 244-46 (the court noted that the risk the company “might not be able to obtain financing” had been disclosed, but that such a disclosure can be found in almost any announcement). The case involved other disclosures as well. *Id.* at 240-48.

<sup>37</sup> *Id.* at 245.

<sup>38</sup> *Id.* at 246.

### C. *Dura* Without the Teeth: A Broad Reading of the Zone of Risk or Subject Matter Test

On similar facts, however, other courts have been willing to find a causal connection between a still hidden misstatement and a market moving disclosure. In *In re Loewen Group Inc. Securities Litigation*, the alleged misstatement was the overstatement of revenue figures.<sup>39</sup> The stock fell when the company disclosed certain accounting charges and a failure to meet earnings forecasts.<sup>40</sup> The court denied the defendants' motion for summary judgment. Applying the zone of risk test, the court reasoned that "the stock price fell as a result of the defendants' failure to properly record [revenue]."<sup>41</sup> It accepted the argument that "the failure to meet expectations was a result of" the accounting improprieties.<sup>42</sup>

Similarly, in *Montalvo v. Triplos*, the defendant company allegedly overstated revenue from software licenses.<sup>43</sup> Before this overstatement became known, the company missed an earnings target relating to its consulting line of business and lowered its guidance with respect to the same line of business. Its stock fell sharply.<sup>44</sup> Some eighteen months later, the company restated its financial statements, acknowledging that it had overstated revenue from software.<sup>45</sup> The plaintiffs argued that the earnings misstatement was a cause of the price drop. Citing *Lentell's* zone of risk test, they contended that, because of the revenue overstatement, the company's "reported results were far less predictive of future results than investors would ordinarily expect."<sup>46</sup> The court agreed, concluding that the plaintiffs' allegation that the company "could not achieve its earnings targets because those targets were based on false financial statements" suggested a sufficient causal connection to survive a motion to dismiss.<sup>47</sup>

Another example is *Sekuk Global Enterprises v. KVH Industries, Inc.*<sup>48</sup> There, the defendant manufacturing company allegedly overstated revenue relating to one of its products.<sup>49</sup> The company's stock dropped after the company announced a failure to meet earnings projections. The company attributed the shortfall in part to weak sales of the product involved in the fraudulent accounting, but did not disclose that the accounting had been wrong.<sup>50</sup> Plaintiffs argued that this disclosure of an earnings shortfall satisfied *Dura* because with it the defendant's "problems became known to the public."<sup>51</sup>

<sup>39</sup> 395 F. Supp. 2d 211, 213-15 (E.D. Pa. 2005). The misstatement was the failure to comply with GAAP by recognizing imputed income on certain contracts. The company later made three disclosures that revealed this earlier non-GAAP accounting, but none of those disclosures affected the company's stock price.

<sup>40</sup> *Id.* at 214.

<sup>41</sup> *Id.* at 218. They did not expressly identify the zone of risk test, but cited the articulation of the test in *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 510 (S.D.N.Y. 2005). *Id.*

<sup>42</sup> 395 F. Supp. 2d at 215.

<sup>43</sup> 2005 WL 2453964, at \*5 (E.D. Mo. Sept. 30, 2005).

<sup>44</sup> *Id.* at \*4-5.

<sup>45</sup> *Id.*

<sup>46</sup> Lead Plaintiffs' Joint Response to the Supplemental Memoranda Filed by the Defendants in Support of Their Motions to Dismiss at 4 (May 6, 2005).

<sup>47</sup> 2005 WL 2453964, at \*9.

<sup>48</sup> 2005 WL 1924202 (D.R.I. Aug. 11, 2005).

<sup>49</sup> *Id.* at \*3.

<sup>50</sup> *Id.* at \*2, \*16.

<sup>51</sup> *Id.* at \*16.

The court agreed, concluding that the plaintiffs met their burden of pleading loss causation because they alleged that the price of defendants' stock "dropped after the truth regarding the Defendants' misrepresentations became known."<sup>52</sup>

A final example is *In re Retek Inc. Securities*.<sup>53</sup> There the misstatements involved the false reporting of revenue and overstatement of certain customer and business relationships.<sup>54</sup> The market moving disclosure was an announcement that sales were weak and that the company had lowered its earning guidance.<sup>55</sup> The accounting misstatements became public only later.<sup>56</sup> Plaintiffs argued that the misrepresentations, which remained hidden at the time the stock price fell, and the disclosure of weak sales were "inextricably linked."<sup>57</sup> The link, the plaintiffs argued, was that the misstatements "were part of a larger scheme" that "began to be disclosed" when the company announced the weak sales.<sup>58</sup> Ruling for the plaintiffs, the court held that the weak-sales disclosure related to the "same products and sales" as the misrepresentations, so that a "subject matter connection" existed.<sup>59</sup> The court explained that it suffices if a disclosure reveals the company's "true financial condition" and is "at odds with the defendants' previous alleged misrepresentations concerning its financial condition."<sup>60</sup>

### 3. Which Path Is Consistent With *Dura*?

Which of these approaches is more faithful to *Dura*? Only the first group. The cases in the second group respect neither *Dura's* holding nor the principles the Supreme Court articulated in that case.

The difference is the approach to the proper level of generality at which to describe the risk hidden by the misstatement, or the "subject" that misstatement addresses. The risk or subject can be described at a more specific level, corresponding to the scope of the misstatement, or at a more general level, where risk and subject refer to the company's financial condition as a whole. The more generally one describes the risk, the more relaxed the test, and the easier it is to show loss causation. The first group above operates at a more specific level, the second group at a more general level.

*Dura* provides considerable guidance to selecting the appropriate level of generality. *Dura's* holding requires courts to ensure that the "relevant truth"—that is, the "misrepresentation" and not something else—"caused" the loss.<sup>61</sup> *Dura* thus specifies a narrowing from a more general truth to a "relevant truth." This is the same narrowing that is reflected in the common law distinction between but-for and proximate causation. *Prosser and Keeton on the Law of Torts*, cited by the Supreme Court in *Dura*, explains that proximate cause sorts out the legally relevant cause from the wider set of but-for causes.<sup>62</sup> The proximate cause is the condition or event

<sup>52</sup> *Id.* at \*16-17.

<sup>53</sup> 2005 WL 3059566 (D. Minn. Oct. 21, 2005).

<sup>54</sup> *Id.* at \*1.

<sup>55</sup> *Id.* at \*2.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at \*3.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* at \*4 (emphasis added).

<sup>60</sup> See *Lentell*, 396 F.3d at 173, 175 for the court's use of "zone of risk" and "subject."

<sup>61</sup> 544 U.S. at 346.

<sup>62</sup> *Prosser and Keeton* § 110, at 767 (cited in *Dura*, 544 U.S. at 344-45).

that is immediately next to—“proximate” to—the loss and is connected to the reason the conduct at issue was wrongful.<sup>63</sup>

In *Dura*, the Supreme Court repeatedly emphasized that this distinction is central to securities fraud cases.<sup>64</sup> The Court cited a long list of sources for the point. It specifically equated loss causation with proximate cause, and it emphasized the distinctness of loss causation as an element of fraud. It stated that the securities fraud defendant is not the “insurer” of a plaintiff’s loss.<sup>65</sup> An insurer covers losses regardless of their cause, while a tort defendant covers only losses with the appropriate proximate cause.

In the context of securities fraud, the set of but-for causes is quite large. It includes all of the many facts or events that affected the company’s condition at the time that the stock price fell.<sup>66</sup> The set of proximate causes—the “relevant truth”—is much smaller; it includes only the facts or events that relate to the wrong at issue and are proximate or “next to” the loss. *Dura* specifically discusses some “but-for” facts that a proximate cause test should filter out. These include a “tangle of factors” that can affect stock price such as “changed economic circumstances” and “new industry-specific or firm-specific facts, conditions or other events.”<sup>67</sup> These other events are, according to the Supreme Court, nothing more than “necessary condition[s] of a loss”<sup>68</sup>—in the language of tort law, mere but-for causes.

To comply with *Dura*, any test must reflect this distinction. But the zone of risk test does nothing to narrow but-for to proximate cause unless the zone or subject is described at a low level of generality. The more generally a court describes the zone or subject, the more facts and events the test sweeps into the set of proximate causes. At the highest level of generality, the test sweeps in virtually all facts and events that affected the company’s stock price.

By definition, every misstatement misrepresents the risk of the investing in the company. If a court expands the “subject” covered by the misstatement to include the general fact that the company was in worse financial condition than previously disclosed, as explicitly done in *Retek* and *Triplos*, the court will find that every material misstatement is a proximate cause of later bad news. Under this approach, the test fails to screen out even events that take place after the misstatement and ordinarily would be considered intervening causes. Plaintiffs always can allege that, because of the still hid-

den misstatement, the company was more vulnerable to the subsequent event than plaintiffs had realized.

At that generalized level, this test amounts to the “touches upon” approach that *Dura* specifically rejected.<sup>69</sup> Indeed, at that generalized level, the zone of risk or subject test eliminates loss causation as a distinct element of securities fraud. It conflates loss causation, not only with the transaction causation requirement, but with the material misrepresentation requirement as well.<sup>70</sup> Under this relaxed standard, whenever a material misrepresentation is present, by definition loss causation also is present. This elimination of loss causation as a distinct requirement is exactly the outcome that *Lentell* itself warned against.<sup>71</sup> And it effectively negates *Dura* itself, because it reestablishes inflation as the test for loss causation.<sup>72</sup>

It is worth noting the likely response to this argument. “Be realistic,” a plaintiff might protest, “of course fraudulently misstated financials are responsible when an investor loses money because a company fails. Consider a company that fraudulently overstated revenue. The company could not meet its earnings target, and its stock price fell. If the company were not overstating revenue, it would not have had this earnings problem.”

This response confuses the connection between misstatement and price decline. On the facts described in *Loewen*, *Retek* and *Sekuk*, we simply do not know whether the earnings shortfalls (and similar disclosures) would have occurred even if the financial statements had been as represented. (*Triplos* is even worse, because the earnings disappointment there related solely to defendant’s consulting business and bore no relationship to the misstatement of revenue for its software business.) In many such cases, it is likely that the misstatement and the market moving disclosure share a common cause: the company’s poor financial health. When that is so, the fraudulent effort to hide that poor

<sup>63</sup> *Dura*, 544 U.S. at 344 (citing Thomas M. Cooley, *Law of Torts* § 348, p. 551 (4th ed. 1932)).

<sup>64</sup> 544 U.S. at 343-44.

<sup>65</sup> *Id.* at 345. Applied to our context, the set of but-for causes can include any fact or event that affected the company’s condition at the time that the stock price fell, *id.* at 343; proximate cause—the relevant truth includes only facts or events that bear more directly on the wrong at issue and are proximate or “next to” the loss.

<sup>66</sup> See *Bastian*, 892 F.2d at 685 (“No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation.”); *Lentell*, 396 F.3d at 174 (discussing the impact to the causation analysis by intervening events or “marketwide phenomenon causing comparable losses to other investors”).

<sup>67</sup> 544 U.S. at 343.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* at 343-44. The difference in levels of generality is illustrated by *Lentell*, where the court drew the line at a low level, specific reading of the relevant risk. That case addresses allegations that falsely optimistic analyst reports on stocks caused plaintiffs who relied on them to lose money when the stock fell because of the general fall of Internet stocks. The court confirmed a district court holding that plaintiffs had not established loss causation. The Second Circuit identified the risk as being the alleged falsity of the analyst opinions, not (as plaintiffs proposed) the more general risk that the investments were generally not as promising as plaintiffs believed. 396 F.3d at 176. The same is true of *Bastian*, 892 F.2d at 685, which *Dura* cites with approval. That court described the risk at a more specific level, as involving, the competence of the broker, and declined to articulate it as the more general level of the risk presented by the investment. *Id.* at 684-86.

<sup>70</sup> Maintaining the distinction between transaction causation and loss causation is an ongoing concern in loss causation cases. See, e.g., *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997).

<sup>71</sup> *Lentell*, 396 F.3d at 173. In the same case at the trial court level, Judge Pollack gave a detailed explanation of why the transaction causation and loss causation requirements should not be conflated. *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003).

<sup>72</sup> See 15 U.S.C. § 78u-4(b)(4) (“the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages”).

health is not the cause of the stock drop when the poor health became known.<sup>73</sup>

The plaintiff's argument therefore *assumes* the very link that it has the burden to prove. *Dura* foresaw this same problem in observing that the "lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events, which taken separately or together account for some or all of that lower price."<sup>74</sup>

The likely plaintiff's argument highlights a possible confusion caused by the "zone of risk" or "subject" approach. Even when this test is expressed in a highly generalized way, it can have intuitive appeal because it blames the defendant for a misstatement that *hid* the relative risk of investing in the company. But that says only that "you got me into this"—that the plaintiff would not have *purchased* the stock, and therefore would not have suffered the loss, if not for the misstatement. That assertion addresses only the inflation in the stock price. This is precisely the argument rejected by *Dura's* core holding,<sup>75</sup> which requires a causal link with the *decline* in price.<sup>75</sup>

#### 4. Bringing the Meaning of 'Subject' and 'Zone of Risk' Into Line With *Dura*

So there must be an upper limit to the permissible generality of the "zone of risk" or the "subject" at issue. To identify that limit, a good place to start is by reference to the fraud on the market theory that provides the basis for these cases in the first place.<sup>76</sup> Both the fraud on the market theory and the zone of risk test rest on the assumption that the *market* is fooled by a material misstatement. With respect to loss causation, both assume that the misstatement misled the market on the same fact that, when it became known, caused the market to devalue the stock. We can look, therefore, to the *market* to provide the content to the zone of risk test, by telling us whether a relationship existed between the misstatement and the market moving disclosure.

The zone of risk test considers whether, in the eyes of the market, the initial misstatement and the market moving disclosure share a factual connection. If such a factual connection exists, then the disclosure of the market moving event should, at least, trigger questions about the accuracy of earlier disclosures. If the market moving event does cause the market to suspect the relevant misstatement, then the market moving event probably lies within the zone of risk that the misstatement hid.<sup>77</sup> On the other hand, if the market moving event does not raise any questions about the company's earlier statements, then the event probably does not lie within that hidden zone of risk.<sup>78</sup> The issue becomes

whether plaintiffs can present *some* evidence from the market that a possible connection exists.

This suggests an additional response to a plaintiff's appeal to apparent common sense: Given an efficient market, if the market moving event were within the zone of risk created by the misstatement, surely some analyst, or some sophisticated investor, would have said, "Something is up. How can this latest event have occurred if the company's financials are as represented? We should look into whether an earlier report was misstated." If no one watching the company thought to suspect this, the response concludes, then it is hard to say that the two are so obviously connected.

We see this kind of inference in *In re Daou Systems, Inc.*<sup>79</sup> In that case an analyst inferred, based on a quarterly earnings report that differed substantially from information and projections the company provided during conference calls with analysts, that it appeared that the company had been "manufacturing earnings."<sup>80</sup>

Ultimately, the language of the zone of risk or subject test does not sit well with the *Dura* requirement for a causal link between the misstatement and the price decline. This is especially true when the misstatement is in the financial statements. The zone of risk test readily suggests distinctions between but-for and proximate cause in cases like *Suez Equity* and *Emergent Capital*, where the misstatement was the quality of the management, and the loss was specifically attributable to management incompetence.<sup>81</sup> But in cases where the misstatement is in the financial statements, it is harder to identify a loss that is *not* caused by the fact that the company was financially weaker or riskier than the financial statements indicated.

#### Conclusion

As some post-*Dura* courts have applied the "zone of risk" test, it fails to provide the screening effect traditionally provided by the proximate cause requirement. This discussion has attempted to show that *Dura* itself identified principles that direct the application of the

ment, but only for the time reasonably required for the efficient market, now informed by the market moving event, to detect the misstatement. The *Enron* court rejected the argument for requiring a temporal connection between disclosure and decline on the theory that this "would mean that the more complex, intricate, and convoluted a scheme . . . the more likely [the defendants] would be to escape liability." *In re Enron Sec. Litig.*, 439 F. Supp. 2d 692, 724 (S.D. Tex. 2006). It should, however, be possible to show that the market moving disclosure led in some way to the corrective disclosure; if the time lag is too long, and there was no ongoing inquiry, then it is not likely that the circumstances of the market moving disclosure included the circumstances concealed by the misstatement. And if the delay resulted from the "impenetrable" nature of the company's accounting, *id.*, the focus on that very impenetrability is likely to coincide with a price decline.

<sup>79</sup> 411 F.3d 1006 (9th Cir. 2005).

<sup>80</sup> *Id.* at 1026.

<sup>81</sup> In *Suez Equity Investors*, the misstated fact was a background report on management that concealed events that reflected management's ability to manage debt and maintain adequate liquidity. 250 F.3d at 93-94. The event disclosed at the time of the stock drop was a liquidity crisis that, critically, the disclosure "expressly attributed . . . to the executive's inability to manage the company's finances." *Id.* See discussion in *Emergent Capital*, 343 F.3d at 198. See also *id.* at 192, 197-98 (holding that the complaint contained "legally sufficient allegations of a causal connection between the subject matter of [the company's] omissions" and the stock price decline).

<sup>73</sup> This insight is one of the premises of so-called "deepening insolvency theory." See an overview of this theory in Sabin Willett, *The Shallows of Deepening Insolvency*, 60 Bus. Law 549 (2005).

<sup>74</sup> *Dura*, 544 U.S. at 343.

<sup>75</sup> *Id.* at 336, 343, 346.

<sup>76</sup> Instead of creating much of the confusion that surrounds the use of but-for and proximate cause concepts in fraud-on-the-market cases.

<sup>77</sup> Defendants should insist that plaintiffs plead these facts with sufficient specificity to satisfy the PSLRA's heightened pleading standard. See *In re First Union Corp. Sec. Litig.*, 2006 WL 163616, at \*4-7.

<sup>78</sup> This test can justify a time lag between the market moving disclosure and the disclosure or discovery of the misstate-

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zone of risk test. Advocates who keep these principles in mind may persuade future courts to refine that test to bring it into line with *Dura*. Awareness of the broader

meaning of *Dura* can help keep the law on track on other loss causation questions as well.