5-1-2014

Why Didn't You Sell?: How Federal Courts are Unfairly Penalizing Defrauded Investors for Unrelated, Post-Corrective Disclosure Stock Gains

Samir Kurani

Why didn't you sell?: How Federal Courts are Unfairly Penalizing Defrauded Investors for Unrelated, Post-Corrective Disclosure Stock Gains

By Samir Kurani

I. INTRODUCTION

Do you know what it feels like to be swindled? George W. Bowen did.[1] In January of 1904, an agent of the Aetna Indemnity Company ("Aetna") persuaded Mr. Bowen to purchase ten shares of Aetna stock for $125 per share by representing that each share had a par value of $100.[2] The stock actually issued to Mr. Bowen, however, had a par value of only $50. Mr. Bowen consequently suffered a loss of $50 per share—the approximate equivalent of $1,258 per share today.[3] In the melee of the unprecedented market growth preceding the Great Depression, many other investors were similarly defrauded.[4]

In response, Congress passed the Securities and Exchange Act of 1934 ("the Exchange Act").[5] Section 10(b) of the Exchange Act made it unlawful to employ a manipulative or deceptive device in connection with the purchase or sale of securities in contravention of Securities and Exchange Commission (SEC) regulations.[6] Pursuant to this statutory authority, the SEC promulgated Rule 10b-5.[7] Securities fraud regulations such as Rule 10b-5 are important because they protect investors and maintain public confidence in securities markets.[8]

---

[1] Bowen v. Aetna Indemnity Co., 160 Iowa 548 (1913).
[2] *Id.* at 205.
[3] *Id.* at 206.
[4] *See* EDWARD T. MCCORMICK, UNDERSTANDING THE SECURITIES ACT AND THE S.E.C. 14 (1948).
[5] 15 U.S.C.A. § 78 (West 2012); *see* James D. Gordon III, *Acorns and Oaks: Implied Rights of Action Under the Securities Acts*, 10 STAN. J.L. BUS. & FIN. 62, 64 (2004) ("When Congress passed enacted the securities acts, it was painfully aware of the Great Depression and believed that it was largely precipitated by abuses in the securities markets.").
[6] 15 U.S.C.A. § 78j(b) (West 2012).
[7] 17 C.F.R. § 240.10b-5 (2012).
[8] *See* A.S. Goldman & Co., Inc. v. New Jersey Bureau of Sec., 163 F.3d 780, 788 (3d Cir. 1999); MCCORMICK, *supra* note 4, at 11; Gordon, *supra* note 5, at 64.

A hypothetical factual scenario that may give rise to a Rule 10b-5 claim appears as follows:

> Corporation X reports that it sells 100 widgets every month. Corporation X's stock price is high. Investors, encouraged by reported widget sales, buy millions of dollars worth of Corporation X stock. It is then revealed that Corporation X misrepresented true widget sales, which had in actuality been only ten widgets per month. Corporation X's stock price plummets and investors lose millions. The investors now have a Rule 10b-5 claim against Corporation X for securities fraud.[9]

In order to recover under Rule 10b-5, Corporation X shareholders would have to prove (1) a material misrepresentation or omission; (2) scienter (i.e., 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.[10]

A rift has recently arisen regarding the economic loss and loss causation elements that threatens to undermine the purposes of Rule 10b-5. Prior to 2005, there was a circuit split regarding the Rule 10b-5 loss causation standard.[11] The majority view required a plaintiff to prove that disclosure of a company's fraud caused the value of the plaintiff's stock to decline.[12] The minority view held that a plaintiff must merely establish that the defendant's fraud artificially inflated the plaintiff's purchase price.[13] The United States Supreme Court resolved the circuit split in its 2005 decision, *Dura Pharmaceuticals v. Broudo*.[14] The Court held that to survive a motion to dismiss, a 10b-5 plaintiff must allege that disclosure of the defendant's fraud

---

[9] *See* 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, 2661 (2010).
[10] Dura Pharm. v. Broudo, 544 U.S. 336, 341–42 (2005).
[11] 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).
[12] *Id.* at 1782.
[13] *Id.*
[14] 544 U.S. 336, 345 (2005).

caused the value of his stock to decline, as opposed to merely pleading that the fraud inflated the plaintiff's purchase price.[15]

Beginning with *Malin v. XL Capital*, United States district courts have interpreted *Dura* to require the dismissal of 10b-5 claims if, after disclosure of the defendant's fraud, the plaintiff's stock increased in value to above his average purchase price.[16] The United States District Court for the Southern District of New York then applied the *Malin* rule in *In re China North East Petroleum Holdings*.[17] The *China North* court held that the plaintiffs did not suffer an economic loss under Rule 10b-5 because their stock's post-disclosure price appreciated to above their purchase price and, consequently, dismissed the complaint.[18] Thereafter, in a case of first impression, the United States Court of Appeals for the Second Circuit bucked the trend and reversed the district court.[19] The Second Circuit held that the *Malin* rule was inconsistent with both the out-of-pocket measure of damages applied in Rule 10b-5 cases and statutory authority that imposes a markedly different cap on a 10b-5 plaintiff's damages.[20]

---

[15] *Id.* at 344.

[16] *In re* Immucor, Inc. Sec. Litig., No. 1:09-CV-2351-TWT, 2011 WL 2619092 (N.D. Ga. June 30, 2011), *reh'g denied*, 2011 WL 3844221 (Aug. 29, 2011); *In re* China N.E. Petroleum Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351 (S.D.N.Y. 2011), *rev'd sub nom. Acticon*, 692 F.3d 34; *In re* Veeco Instruments, Inc. Sec. Litig., No. 05-MD-01695 (CM)(GAY), 2007 WL 7630569 (S.D.N.Y. June 28, 2007), *abrogated by Acticon*, 692 F.3d 34; Ross v. Walton, 668 F. Supp. 2d 32 (D.D.C. 2009); *In re* Estee Lauder Companies Sec. Litig., No. 06 Civ. 2505 (LAK), 2007 WL 1522620 (S.D.N.Y. May 21, 2007), *abrogated by Acticon*, 692 F.3d 34; Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089 (D. Conn. Sept. 1, 2005), *abrogated by* Acticon AG v. China N.E. Petroleum Holdings Ltd., 692 F.3d 34 (2d Cir. 2012).

[17] *China North*, 819 F. Supp. 2d 351.

[18] *Id.* at 354.

[19] Acticon AG v. China N.E. Petroleum Holdings, Ltd., 692 F.3d 34 (2d Cir. 2012); Sarah R. Wolff and Jennifer L. Achilles, *Second Circuit Holds that Stock Price Rebound After Disclosure of Fraud Does Not Negate Inference of Economic Loss at Pleading Stage of a Securities Fraud Suit*, MONDAQ, http://www.mondaq.com/unitedstates/x/193770/White+Collar+Crime+Fraud/Second+Circuit+Holds+that+Stock+Price+Rebound+after+Disclosure+of+Fraud+Does+Not+Negate+Inference+of+Economic+Loss+at+Pleading+Stage+of+Securities+Fraud+Suit (last visited Aug. 28, 2012).

[20] *Acticon*, 692 F.3d 34. 41. Under the out-of-pocket rule, the plaintiff's damages are equal to the difference between what he paid for the securities and their actual value on the date of purchase—that is, the value of the securities absent the fraud. *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1976); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965), *cert. denied*, 382 U.S. 879 (1965). The pertinent statutory authority is a provision in the Private Securities Litigation Reform Act which caps a 10b-5 plaintiff's damages at the difference

This Comment argues that the Second Circuit's approach is superior because the *Malin* rule unnecessarily increases transaction costs and is inconsistent with the reasoning put forth by the *Dura* Court. This Comment further proposes that district courts hearing 10b-5 claims should strive to determine whether post-disclosure price rebounds are a market correction to an initial overreaction to disclosure of the fraud. If they are, then offsetting the plaintiff's damages is appropriate. If the subsequent gain is, however, unrelated to the fraud, then offsetting is inappropriate. Post-disclosure unrelated gain represents income that the plaintiff-shareholder is entitled to receive due to his investment. Consequently, relabeling this post-disclosure, unrelated gain as compensation to the investor by barring his Rule 10b-5 claim is unjust and should not be permitted.

Part II of this Comment trace the history and relevant components of the securities laws and the SEC Rule 10b-5 claim. Part II then explains the elements of a 10b-5 claim and how *Dura Pharmaceuticals* affects the 10b-5 plaintiff's consequent economic loss pleading requirements. Part III describes how courts have applied the *Dura* standard to cases where there has been a post-corrective disclosure price recovery. Part IV explains why post-disclosure price recovery should not preclude an inference of economic loss because such preclusion would unnecessarily increase transactions costs and is contrary to the reasoning set forth in *Dura*.

II. THE SECURITIES LAWS, S.E.C. RULE 10b-5, AND THE 10b-5 CLAIM

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

"*Those who cannot remember the past are doomed to repeat it*."[21]

Courts ought not forget the circumstances that bring about congressional legislation, lest the evils it was designed to prevent be permitted to resurface.[22] The Securities Act of 1933 ("the

between the plaintiff's purchase price and the average trading price of that security during the 90-day period after the corrective disclosure. 15 U.S.C.A. § 78u–4(e)(1) (West 2012).

[21] GEORGE SANTAYANA, REASON IN COMMON SENSE: THE LIFE OF REASON 284 (1905).

Securities Act")[23] and the Exchange Act,[24] passed in the midst of the Great Depression, are no exception. Thus, a brief description of the context in which Rule 10b-5 was promulgated will aid the subsequent discussion of the 10b-5 economic loss requirement.

The stock market crash of 1929 was one of the most devastating in the history of financial markets.[25] During the preceding decade, American businesses prospered, and the value of securities[26] experienced remarkable growth.[27] Due to enormous profit potential and ineffective oversight,[28] subterfuge became a well-practiced art by well-known and obscure firms alike.[29] Fraudulent promoters and high-pressure salesman preyed on inexperienced investors and induced them to invest in extremely risky securities.[30] A review of the practices of certain securities issuers during this period reveals an utter disregard for the well being of investors.[31]

During the 1920s, money flowed so freely that businesses could not resist the urge to issue securities beyond their current need for capital.[32] Of the $50 billion worth of securities floated[33] between the end of World War I and the early 1930s, about half turned out to be

---

[22] *See, cf.*, STEPHEN BREYER, ACTIVE LIBERTY 86 (2005) (noting that most judges begin the process of statutory interpretation by considering, inter alia, the statute's history).
[23] Securities Act of 1933, 15 U.S.C.A § 77 (West 2012).
[24] 15 U.S.C.A. § 78 (West 2012).
[25] *See* JOHN KENNETH GALBRAITH, THE GREAT CRASH: 1929, at 111 (1955). On October 24, 1929, the first day of panic, the Dow Jones Industrial Average (DJIA) opened at 305.85. Harold James, *1929: The New York Stock Market Crash*, REPRESENTATIONS (Spring 2010) at 133. By July 8, 1932, the DJIA had reached a low of 40.56, wiping out about $20 billion of wealth. *Id.* at 135–36.
[26] "Securities," in a legal sense, is a flexible principle that refers to financial assets sold "by those who seek the money of others on the promise of profits." Tcherepnin v. Knight, 389 U.S. 332, 338 (1967) (quoting S.E.C. v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)). The Exchange Act provides an extensive categorical list of financial instruments that are securities including notes, stocks, futures, bonds, options, and "any instrument commonly known as a 'security.'" 15 U.S.C.A. § 78(c) (West 2012).
[27] *See* MCCORMICK, *supra* note 4, at 18.
[28] *See* MICHAEL E. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 28–41 (1970).
[29] *See id.* at 29.
[30] *See* MCCORMICK, *supra* note 4, at 14, 19–20.
[31] *See id.* at 19.
[32] *See id.* at 18.
[33] "Floating" refers to a firm's initial sale of securities to raise capital. ZVI BODIE ET AL., INVESTMENTS 57 (7th ed. 2008).

worthless.[34] The wild speculation led to inflated and unsupportable securities prices and culminated in the stock market crash of 1929 and the subsequent Great Depression.[35] In the wake of the crash, America's faith in securities markets was crushed.[36] Since the financial markets are an indispensable element of the American economy,[37] Congress sought to revive public confidence in them by passing the securities acts.[38]

The Securities Act mandates disclosure of material information and seeks to prevent fraud in the primary market.[39] In contrast, the Exchange Act addresses a wide range of issues regarding the secondary market,[40] such as fraud, price manipulation, and insider trading.[41] Congress also used the Exchange Act to create the SEC and vest it with flexible enforcement and administrative powers over federal securities laws.[42]

B. *Section 10(b) of the Exchange Act and S.E.C. Rule 10b-5*

Section 10(b) of the Exchange Act[43] and SEC Rule 10b-5[44] promulgated thereunder are the preeminent federal antifraud provisions governing the secondary market.[45] Securities fraud

---

[34] *See* H.R. REP. NO. 73–85, at 2 (1933).
[35] *See* MCCORMICK, *supra* note 4, at 19–20.
[36] *See* PARRISH, *supra* note 28, at 43.
[37] *See* Gordon, *supra* note 5, at 64.
[38] *See id.* ("When Congress enacted the securities acts, it was painfully aware of the Great Depression and believed that it was largely precipitated by abuses in the securities markets.").
[39] *See* WILLIAM A. KLEIN, BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 399 (8th ed. 2012). "Primary market" refers to the aggregate of sales of new issues of securities to the public. BODIE, *supra* note 33, at 57. In advocating for passage of the Securities Act, President Franklin D. Roosevelt told Congress that "[t]his proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence." H.R. REP. NO. 73–85, at 2 (1933). The purpose of the securities acts was to achieve full disclosure and "a high standard of business ethics in the securities industry." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).
[40] The "secondary market" is the aggregate trading of previously issued securities among investors. BODIE, *supra* note 33, at 57.
[41] *See* KLEIN, *supra* note 39, at 57.
[42] 15 U.S.C.A. § 78d (West 2012); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); William F. Schneider, *Implying Private Rights and Remedies Under the Federal Securities Acts*, 62 N.C. L. REV. 853, 859 (1984).
[43] 15 U.S.C.A. § 78j(b) (West 2012).
[44] Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2012).
[45] Hill, *supra* note 9, at 2661.

regulations are important because if registration, disclosure, or licensing requirements fail, the courts can still protect investors through securities fraud prosecution and litigation.[46] Section 10(b) provides in pertinent part that it shall be

> unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security, . . . 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 and for the protection of investors.[47]

In 1942, the SEC exercised its power to promulgate rules under Section 10(b) by issuing Rule 10b-5 entitled "Employment of Manipulative and Deceptive Practices" and providing as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[48]

Liability under Rule 10b-5 and Section 10(b) is coextensive—that is, both rules necessarily prohibit the same conduct.[49]

C. *Implied Private Causes of Action for Violations of Section 10(b) and Rule 10b-5—The 10b-5 Claim*

---

[46] *See* MCCORMICK, *supra* note 4, at 11; *see also* Keith A. Rowley, *Cause of Action for Securities Fraud Under Section 10(b) of the 1934 Securities Act and/or Rule 10b-5*, 9 CAUSES OF ACTION 271 § 1 (2d ed. 1997) (noting that Section 10(b) and Rule 10b-5 are "catch all" provisions designed to protect investors from situations not covered by other provisions); A.S. Goldman & Co., Inc. v. N.J. Bureau of Sec., 163 F.3d 780, 788 (3d Cir. 1999) (explaining that securities registration laws are intended to prevent fraud before it happens).

[47] 15 U.S.C.A. § 78j(b) (West 2012).

[48] 17 C.F.R. § 240.10b-5 (2012).

[49] United Stated v. O'Hagan, 521 U.S. 642, 651 (1997).

The efficacy of securities fraud regulations depends almost entirely upon the effectiveness of the governmental entity chosen for enforcement, here, the SEC and federal courts.[50] Perhaps to that end, in 1946, the United States District Court for the Eastern District of Pennsylvania recognized an implied private cause of action[51] under Section 10(b) of the Exchange Act and SEC Rule 10b-5 (the private cause of action is hereinafter referred to as the "10b-5 claim").[52] In 1971, the United States Supreme Court first affirmed the implied private cause of action under Section 10(b) and Rule 10b-5.[53] Since 1946, 10b-5 claims have grown from a "legislative acorn" into a "judicial oak"[54] that is arguably the most important private right of action in United States securities law today.[55]

Because the private cause of action is not a Congressional product, it has fallen to the courts to determine the elements of a 10b-5 claim.[56] As it now stands, the basic elements are: (1) a material misrepresentation or omission; (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation.[57] Because knowledge of the requisite elements in a Rule 10b-5 private cause of action is helpful in understanding why post-disclosure price recovery should not negate an inference of economic loss, this section sets forth a brief description of the elements.

1. Materiality

---

[50] *See* MCCORMICK, *supra* note 4, at 11.
[51] A "private cause of action" refers to "the right of a private party to seek judicial relief from injuries caused by another's violation of a" statutorily imposed duty. Cannon v. Univ. of Chi., 441 U.S. 677, 730 (1979) (Powell, J., dissenting). The general idea is that if a statute is enacted to protect the interests of certain individuals, such individuals, when injured by a violation of the statutorily imposed duty, are entitled to recover damages caused thereby. Schneider, *supra* note 42, at 861–62.
[52] *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946).
[53] Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).
[54] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).
[55] *See* KLEIN, *supra* note 39, at 433.
[56] *See* Matthew L. Fry, *Pleading and Proving Loss Causation in Fraud-on-the-Market-Based Securities Suits Post-Dura Pharmaceuticals*, 36 SEC. REG. L.J. 31, 33 (2008); Gordon, *supra* note 5, at 62.
[57] Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005); *see also* Stoneridge Inv. Partners LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008); Gasner v. Bd. of Supervisors, 103 F.3d 351, 356 (4th Cir. 1996).

To be actionable under Rule 10b-5, a misrepresentation must be material.[58] Materiality is determined from the viewpoint of the investor.[59] Under Rule 10b-5, a misrepresentation or omission is material if there is a "substantial likelihood" that proper disclosure "would have been viewed by the reasonable investor as having altered the 'total mix' of information made available."[60] Where the impact of certain factual circumstances on a corporation is "certain and clear," the materiality of disclosure is relatively easy to ascertain.[61] In contrast, where the pertinent information includes "subjective analysis or extrapolation,"[62] the materiality of disclosure is more difficult to determine[63] and requires a detailed factual analysis.[64] For example, in *Basic v. Levinson*, the Supreme Court held that the materiality of the nondisclosure of merger negotiations depends on the likelihood that the event will take place and the expected magnitude of the event relative to the totality of the business's activity.[65]

2. Scienter

Scienter is a prerequisite to liability under Rule 10b-5.[66] Put simply, scienter is a wrongful state of mind.[67] The Supreme Court has defined scienter in the Rule 10b-5 context as "a mental state embracing intent to deceive, manipulate, or defraud."[68] To prove scienter under Rule 10b-5, a plaintiff must establish that the defendant (1) knew that the representation was false or that the omission would render disclosed information untrue,[69] (2) or made the

---

[58] *Dura*, 544 U.S. at 341; *see also* TSC Indus. v. Northway, Inc. 426 U.S. 438, 449 (1976).
[59] Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 728 (1989).
[60] *TSC*, 426 U.S. 438, 449 (1976); Basic v. Levinson, 485 U.S. 224, 232 (1988) ("We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context.").
[61] *Basic*, 485 U.S. at 232.
[62] Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628 (3d Cir. 1989).
[63] *Basic*, 485 U.S. at 232.
[64] *See, e.g.*, *id.* at 238.
[65] *Id.* (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)).
[66] *See* 15 U.S.C.A. § 78j(b) (West 2012); TSC Indus. v. Northway, Inc., 426 U.S. 438, 449–50 (1976).
[67] Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 441–42 (2005).
[68] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193–94 n.12 (1976).
[69] *See id.* at 212–14.

representation or omission with reckless disregard as to its truthfulness or lack thereof.[70] The United States Court of Appeals for the Seventh Circuit has defined "recklessness" in the Section 10(b) context as "highly unreasonable" conduct constituting "an extreme departure from the standards of ordinary care" that creates such a danger of misleading investors that the defendant either knew or should have known about it.[71] Mere negligence—that is, mere departure from an ordinary standard of care—will not support civil liability under Rule 10b-5.[72]

3. Reliance

Under Rule 10b-5, the plaintiff must establish that he relied on the defendant's misrepresentation.[73] Reliance, also known as "transaction causation" in the Rule 10b-5 context,[74] is established by proving that the defendant's misrepresentation either caused, or was a substantial factor contributing to, the plaintiff's purchase or sale of the relevant securities.[75] Most of the circuits require the plaintiff to prove that his reliance on the defendant's misrepresentation was "reasonable" or "justifiable."[76] The plaintiff is required to prove that although other factors may have induced his transaction,[77] absent the misrepresentation or

[70] *See* Healey v. Chelsea Resources, Ltd., 947 F.2d 611, 618 (1991); Sirota v. Solitron Devices, Inc., 673 F.2d 566, 575 (2d Cir. 1982), *cert. denied*, 459 U.S. 908 (1982).
[71] Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719 (W.D. Okla. 1976)).
[72] *See Ernst*, 425 U.S. at 199 (holding that Congress' use of the words "manipulative," "device," and "contrivance" in Section 10(b) indicates the lack of an intent to prohibit mere negligence).
[73] *See* 15 U.S.C.A. § 78j(b) (2013); TSC Indus. v. Northway, Inc., 426 U.S. 438, 449–50 (1976).
[74] *See, e.g.*, Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb Inc., 967 F.2d 742, 728–29 (2d Cir. 1992).
[75] *See, e.g.*, Healey v. Chelsea Resources, Ltd., 947 F.2d 611, 618 (2d Cir. 1991) (providing substantial factor test); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied* 421 U.S. 976 (1975).
[76] *See, e.g.*, Paracor Fin. v. GE Capital Corp., 96 F.3d 1151, 1159 (9th Cir. 1996); Harsco Corp. v. Segui, 91 F.3d 337, 342 (2d Cir. 1996); Harrison v. Dean Witter Reynolds, Inc., 79 F.3d 609, 618 (7th Cir. 1996), *cert. denied*, 117 S.Ct. 86 (U.S. 1996); Haralson v. E.F. Hutton Grp., Inc., 919 F.2d 1014, 1025 (5th Cir. 1990); One-O-One Enters., Inc. v. Caruso, 848 F.2d 1283, 1286 (D.C. Cir. 1988); Kennedy v. Josephthal & Co., 814 F.2d 798, 804 (1st Cir. 1987); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983).
[77] Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 92 (2d Cir. 1981).

omission he would not have been so induced[78] or would have otherwise prevented the loss caused thereby.[79]

A 10b-5 plaintiff may rely upon a rebuttable presumption of reliance if (1) the claim is based on the defendant's material omission,[80] or (2) the plaintiff alleges that the defendant's misconduct constituted a "fraud on the market."[81] Under the "fraud on the market" theory, where misrepresentations are disseminated into an "impersonal" and "well-developed" financial market, the plaintiff is relieved of the burden of proving individual reliance.[82] Rather than relying on the defendant's misrepresentation, the plaintiff benefits from the presumption that he relied upon the integrity of the security's market price.[83] The defendant may rebut the presumption by proving that (1) the misrepresentation had no affect on the market price, (2) the plaintiff knew of the misrepresentation, or (3) had the plaintiff known of the misrepresentation, he still would have traded at the same price.[84] The fraud on the market rule is premised on the theory that in an efficient market, share price is predicated on all information available to the market, including any misrepresentations.[85] Consequently, misrepresentations may defraud investors even if not directly relied upon.[86]

4. Economic Loss

---

[78] *See* Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 240 (2d Cir. 1974).

[79] *See* Madison Consultants v. Fed. Deposit Ins. Corp., 710 F.2d 57, 65 (2d Cir. 1983); IIT, Int'l Inv. Trust v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980).

[80] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153–154 (1972); Du Pont v. Brady, 828 F.2d 75, 78 (2d Cir. 1987); Titan Group, Inc. v. Faggen, 513 F.2d 234, 239 (2d Cir. 1975), *cert. denied*, 423 U.S. 840 (1975); SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[81] *See, e.g.*, Basic v. Levinson, 485 U.S. 224, 247 (1988).

[82] *Id.* (holding so and noting that nearly every court to consider the issue has also held as such).

[83] *See id.*; Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb, Inc., 967 F.2d 742, 748 (2d Cir. 1992); *In re* Blech Sec. Litig., 961 F. Supp. 569, 586 (S.D.N.Y. 1997).

[84] Fine v. American Solar King Corp., 919 F.2d 290, 299 (5th Cir. 1990) (citing *Basic*, 485 U.S. at 248–49).

[85] *Basic*, 485 U.S. at 241 (quoting Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986)).

[86] *Id.*

A 10b-5 plaintiff must establish that the defendant's misrepresentation proximately caused an economic loss and the extent of damages caused thereby.[87] In determining the extent of economic loss under Rule 10b-5, courts have applied Section 28(a) of the Exchange Act.[88] Section 28(a) provides that "[n]o person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in 1 or more actions, a total amount in excess of the actual damages to that person on account of the act complained of."[89]

Section 28(a) is now commonly understood to require application of the out-of-pocket measure of damages in Rule 10b-5 cases.[90] Under the out-of-pocket rule, the plaintiff's damages equal the difference between what he paid for the securities and their actual value on the date of purchase—that is, the value of the securities absent the fraud.[91] Although the elements of a 10b-5 claim generally, and the out-of-pocket rule specifically, are borrowed from the tort actions of deceit and misrepresentation,[92] there are important differences.[93]

[87] *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345–46 (2005); *Litton*, 967 F.2d at 747; Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).
[88] Feldman v. Pioneer Petroleum, Inc., 813 F.2d 296, 301 (10th Cir. 1987), *cert. denied*, 484 U.S. 954 (1987); Pelletier v. Stuart-James Co., 863 F.2d 1550, 1557 (11th Cir. 1989).
[89] 15 U.S.C.A. § 78bb(a) (West 2012).
[90] *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972) (while considering a 10b-5 claim, holding that the correct measure of damages under Section 28 of the Exchange Act is the out-of-pocket rule); Acticon AG v. China N.E. Petroleum Holdings, Ltd., 692 F.3d 34, 38 (2d Cir. 2012) (noting that "[t]raditionally, economic loss in Section 10(b) cases has been determined by use of the "out-of-pocket" measure for damages."); Sowell v. Butcher & Singer, Inc., 926 F.2d 289, 297 (3d Cir. 1991); Huddleston v. Herman & MacClean 640 F.2d 534, 555 (5th Cir. 1981); Thomas v. Duralite Co., Inc., 524 F.2d 577, 586 (3d Cir. 1975); Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971); Kaufman v. Mellon Nat'l Bank & Trust Co., 336 F.2d 326, 331 (3d Cir. 1966); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965), *cert. denied*, 382 U.S. 879 (1965); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962). *But see* Pelletier v. Stuart-James Co., 863 F.2d 1550, 1558 (11th Cir. 1989) (applying benefit of the bargain measure of damages); Hackbart v. Holmes, 675 F.2d 1114, 1121–22 (10th Cir. 1982) (same); Osofsky v. Zipf, 645 F.2d 107, 111 (2d Cir. 1981) (same); John R. Lewis, Inc. v. Newman, 446 F.2d 800, 805 (5th Cir. 1971) (same).
[91] *See, e.g.*, *Affiliated*, 406 U.S. at 155; *Janigan*, 344 F.2d at 786.
[92] *See Dura*, 544 U.S. 336, 336 (2005) (noting that, in many ways, a 10b-5 claim resembles the common law tort action of deceit and misrepresentation); Harris v. Am. Inv. Co., 523 F.2d 220, 224–25 (8th Cir. 1975) (noting that in 10b-5 cases, federal courts employ an out-of-pocket measure of damages borrowed from the tort action of deceit); *see also* RESTATEMENT (FIRST) OF TORTS § 549 (1938) (outlining the measure of damages for a deceit action).

In a typical deceit action, the seller's misrepresentation is directed solely at the buyer or a small group of prospective buyers, rather than at the public at large.[94] Consequently, the value of the transferred property is readily ascertainable by looking to the open market.[95] The same is not true for "fraud on the market" cases because the misrepresentation is directed at substantially all potential buyers and thus affects the market price.[96] The true value of the securities at the time of the transaction must therefore be ascertained ex post by examining the behavior of the market price in the period immediately following public disclosure of the fraud.[97] In sum, when calculating Rule 10b-5 damages in a "fraud on the market" case, the important factors are the plaintiff's purchase price and any consequent post-disclosure price fluctuations.[98] Even so, the aim of the damages analysis is ascertaining how much more the plaintiff was deceived into paying on the date of purchase due to the defendant's fraud.

In 1995, Congress passed, over President William Clinton's veto,[99] the Private Securities Litigation Reform Act (PSLRA),[100] which, *inter alia*, capped a 10b-5 plaintiff's damages at the difference between the plaintiff's purchase price and the average trading price of that security during the 90-day period ("look back period") after the corrective disclosure (this statutory damages cap is hereinafter referred to as the "look back provision").[101] The purpose of the look

---

[93] *Cf.* Basic Inc. v. Levinson, 485 U.S. 224, 243–44 (1988) ("The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences.").
[94] *Harris*, 523 F.2d 225–26.
[95] *Id.* at 226.
[96] *Id.* (citing RESTATEMENT (FIRST) OF TORTS § 549 cmt. c (1983)).
[97] *Id.*
[98] *See id.*; *see also* H.R. REP. NO. 104-369, at 42 (1995) (Conf. Rep.) (noting that in a 10b-5 claim, the plaintiff's damages are generally the difference between the price paid for the securities and the price of the securities on the day the public becomes aware of the fraud).
[99] Rowley, *supra* note 46, § 3.
[100] Pub. L. No. 104–67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).
[101] 15 U.S.C.A. § 78u-4(e)(1) (West 2012).

back provision is to limit damages to losses caused by the fraud, rather than losses caused by other market conditions.[102]

In drafting the look back provision, Congress was cognizant of the fact that calculating damages based on the security's price on the day of the corrective disclosure often risks substantially overstating damages.[103] Research suggests that markets often overreact when fraud is revealed, and the price at which the security trades immediately following disclosure may not reflect its true value.[104] Hence, the look back provision gives the security an opportunity to recover following a possible market overreaction to a corrective disclosure.[105]

The look back provision, however, is an imperfect solution to the problem of market overreaction because it caps damages regardless of whether the price recovery was actually a market correction to an initial overreaction.[106] Besides capping damages at the mean trading price of the security over the ninety days following the corrective disclosure, the look back provision did not otherwise alter the traditional out-of-pocket measure of damages calculation.[107]

5. Loss Causation

[102] H.R. REP. NO. 104-369, at 42 (1995) (Conf. Rep.).
[103] *Id.*
[104] *See* Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 10 (1994) ("immediately following an important negative corporate announcement, and sometimes for several days thereafter, share price may not reflect a firm's true value").
[105] *See In re* Veritas Software Corp. Sec. Litig. 494 F.3d 962, 967 n.3 (9th Cir. 2003); Richard C. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants, and Lawyers*, 51 BUS. LWYR. 1009, 1060 (1996).
[106] 15 U.S.C.A. § 78u-4(e) (West 2012); *see also* Denis T. Rice, *A Practitioner's View of the Private Securities Litigation Reform Act of 1995*, 31 U.S.F. L. REV. 283, 301 (1997).
[107] Acticon AG v. China N.E. Petroleum Holdings Ltd., 692 F.3d 34, 39 (2012) (citing *In re* Royal Dutch/Shell Trans. Sec. Litig., 404 F. Supp. 2d 605, 609–10 (D.N.J. 2005)).

The PSLRA also codified the judicially mandated Rule 10b-5 loss causation requirement[108] by providing that in private actions arising under the Exchange Act, "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."[109] Courts require a showing of loss causation—that is, a causal connection between the corporation's misrepresentation and the plaintiff's economic loss—to prevent Rule 10b-5 from becoming a form of investor insurance.[110]

Until 2005, although the circuits agreed that a 10b-5 plaintiff must establish loss causation, they disagreed about the governing legal standard.[111] The stricter majority view required a 10b-5 plaintiff to plead and prove that the disclosure of a company's fraud caused a price decline.[112] The minority view held that a 10b-5 plaintiff must merely establish that the defendant's fraud artificially inflated the plaintiff's purchase price.[113]

In 2005, the United States Supreme Court ended the circuit split regarding the Rule 10b-5 loss causation standard with its unanimous, landmark decision, *Dura Pharmaceuticals*.[114] The Supreme Court held that to survive a motion to dismiss, a 10b-5 plaintiff must allege a post-disclosure depreciation in the value of the security, rather than mere purchase price inflation.[115] The *Dura* complaint alleged that Dura Pharmaceuticals, Inc. ("Dura") misrepresented the likelihood of Food and Drug Administration approval of a novel asthmatic spray device, causing

---

[108] The Private Securities Litigation Reform Act of 1995, Pub. L. No. 104–67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).
[109] 15 U.S.C.A § 78u-4(b)(4) (West 2012).
[110] *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005); Rousseff v. E.F. Hutton Co., 843 F.2d 1326, 1329 (11th Cir. 1988).
[111] Escoffery, *supra* note 11, at 1781.
[112] *Id.* at 1782.
[113] *Id.*
[114] *Dura*, 544 U.S. 336.
[115] *Id.* at 344.

the plaintiffs to buy Dura stock at an artificially inflated price and thereby suffer damages.[116] Considering a motion to dismiss, the United States Court of Appeals for the Ninth Circuit reversed the district court and, applying the minority rule, held that the complaint adequately plead loss causation.[117]

In reversing the Ninth Circuit, the Supreme Court noted two reasons why a 10b-5 plaintiff must allege actual economic loss, rather than mere purchase price inflation.[118] First, at the time of the transaction, the court noted, any fraudulently caused price inflation is offset by the fact that the investor owns a highly liquid security that is still worth the inflated price.[119] Second, from a policy standpoint, the Ninth Circuit's holding would transform the 10b-5 claim into a form of investor insurance when, instead, it was provided to compensate investors for actual and consequent losses suffered.[120]

The Supreme Court noted that while an inflated purchase price may be a prerequisite to a consequent depreciation, such depreciation is not inevitable.[121] For example, the investor might sell the securities before the corrective disclosure and thus not suffer any consequent economic loss.[122] Even if the investor holds the securities and experiences a post-disclosure depreciation, the depreciation could be attributable to unrelated events such as changed economic circumstances.[123] Importantly, the Court commented that "[t]he same is true in respect to a claim that a share's higher price is lower than it otherwise would have been."[124] In other words, a post-disclosure price *increase* may not be attributable to a market correction subsequent to a post-

[116] *Id.* at 336–40.
[117] *Id.* at 340.
[118] *Id.* at 342–345.
[119] *Id.* at 342.
[120] *Dura*, 544 U.S. at 345.
[121] *Id.* at 345.
[122] *Id.* at 342.
[123] *Id.* at 342–43.
[124] *Id.* at 343.

disclosure market overreaction. The Supreme Court gave lower courts guidance by positing that the greater the amount of time that has elapsed after the corrective disclosure, the more likely it is that factors unrelated to the disclosure caused the price fluctuation.[125]

In contrast to subsequent judicial interpretations, the Supreme Court's *Dura* decision sought merely to enforce the Rule 10b-5 elements of economic loss and loss causation by requiring plaintiffs to plead more than an inflated purchase price. The *Dura* Court intended to require 10b-5 plaintiffs to plead a post-disclosure depreciation and a casual connection between the depreciation and the fraud.[126]

III. JUDICIAL APPLICATION OF *DURA* TO POST-DISCLOSURE PRICE RECOVERIES

A. *The Pre-*China North *District Courts*

Since 2005, at least six United States District Court decisions have interpreted *Dura* to require courts to dismiss 10b-5 complaints for lack of economic loss if the plaintiff could have sold his shares for a profit after the truth reached the market.[127] This Subsection examines the decisions and the development of this remarkable extension of the Supreme Court's *Dura* holding.

1. *Malin v. XL Capital Ltd.*

[125] *Id.* at 343.
[126] *Dura*, 544 U.S. at 347 (holding that Rule 10b-5 complaints must provide the defendant "with some indication of the loss and the causal connection that the plaintiff has in mind").
[127] *In re* Immucor, Inc. Sec. Litig., No. 1:09-CV-2351-TWT, 2011 WL 2619092 (N.D. Ga. June 30, 2011), *reh'g denied*, 2011 WL 3844221 (Aug. 29, 2011); *In re* China N.E. Petroleum Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351 (S.D.N.Y. 2011), *rev'd sub nom. Acticon*, 692 F.3d 34; *In re* Veeco Instruments, Inc. Sec. Litig., No. 05-MD-01695 (CM)(GAY), 2007 WL 7630569 (S.D.N.Y. June 28, 2007), *abrogated by Acticon*, 692 F.3d 34; Ross v. Walton, 668 F. Supp. 2d 32 (D.D.C. 2009); *In re* Estee Lauder Companies Sec. Litig., No. 06 Civ. 2505 (LAK), 2007 WL 1522620 (S.D.N.Y. May 21, 2007), *abrogated by Acticon*, 692 F.3d 34; Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089 (D. Conn. Sept. 1, 2005), *abrogated by* Acticon AG v. China N.E. Petroleum Holdings Ltd., 692 F.3d 34 (2d Cir. 2012).

Malin v. XL Capital Ltd. was the first case to preclude recovery in a Rule 10b-5 action due to a post, disclosure price recovery.[128] Likely seeking to avoid *Dura*'s ambit, the *Malin* complaint, filed with the United States District Court for the District of Connecticut, alleged price inflation, a disclosure, a subsequent depreciation, and a causal connection between the disclosure and the depreciation.[129] In response, XL Capital Ltd. ("XL") filed a motion to dismiss the complaint[130] on the grounds that, under *Dura*, the plaintiffs failed to adequately plead loss causation because although share price declined after disclosure of the fraud, the price fully recovered prior to the plaintiffs' sale, which negated the inference of economic loss.[131]

The court noted that the plaintiffs' stated intention to prove a causal connection between a post-disclosure price decline and the disclosure met the pleading requirement articulated in *Dura*.[132] Nevertheless, the court equated price decline without loss realization to mere price inflation, which the Supreme Court rejected as inadequate in *Dura*.[133] Consequently, the court held that the stock's post-disclosure increase over the pre-disclosure price negated the requisite inference of economic loss and as a result the court dismissed the plaintiffs' complaint.[134]

2. *In re Estee Lauder Companies Securities Litigation*

Two years later, the United States District Court for the Southern District of New York followed suit in *In re Estee Lauder Companies Security Litigation*.[135] In that case, the complaint alleged that Estee Lauder's stock price was artificially inflated due to "false and misleading"

[128] *Malin*, 2005 WL 2146089.
[129] *Id.* at *3.
[130] Defendants' Memorandum in Support of Rule 12(b)(1) Motion to Dismiss for Lack of Subject Matter Jurisdiction Based Upon Recent Supreme Court Authority Showing Lack of Appearing Plaintiffs' Standing to Assert a Claim Under Section 10(b) of the 1934 Act, *Malin*, 2005 WL 2146089 (No. 3:03 CV 2001 PCD), 2005 WL 2181534.
[131] *Id.* at 2.
[132] *Malin*, 2005 WL 2146089, at *3.
[133] *Id.* at *4.
[134] *Id.*
[135] *In re* Estee Lauder Companies Sec. Litig., No. 06 Civ. 2505 (LAK), 2007 WL 1522620 (S.D.N.Y. May 21, 2007), *abrogated by* Acticon AG v. China N.E. Petroleum Holdings, Ltd., 692 F.3d 34 (2d Cir. 2012).

company statements beginning in April 2005, that were intended to prop up the share price while insiders unloaded their stock.[136] The complaint alleged that Estee Lauder made two corrective disclosures on September 19, 2005, and October 26, 2005, revealing that the company was not performing as well as it had earlier represented.[137] The first disclosure was accompanied by a price decline from $40.51 to $36.05 per share, and upon the second disclosure, the share price declined further to $30.71.[138]

In ruling upon Estee Lauder's motion to dismiss, the court held that the complaint failed to adequately plead loss causation, as a matter of law, solely because the lead plaintiff could have sold his shares at a profit in 2006, after disclosure of the fraud.[139] Perplexingly, the court opined that the plaintiff's argument that a sharp post-disclosure price decline constituted an economic loss was unpersuasive.[140]

3. *In re Veeco Instruments, Incorporated Securities Litigation*

Later that year, in *In re Veeco Instruments*, the United States District Court for the Southern District of New York considered a 10b-5 defendant's motion to exclude from the damages calculation (1) any shares not yet sold by the plaintiffs, and (2) any shares sold after the corrective disclosure at a price equal to or greater than the plaintiff's purchase price.[141] Regarding the shares not yet sold by the plaintiffs, the court noted that "neither the PSLRA nor [*Dura*] imposes such a 'sell-to-sue' requirement"[142] and held that such shares were not *ipso facto*

---

[136] Class Action Complaint for Violation Federal Securities Laws at 3, *Estee Lauder*, 2007 WL 1522620 (No. 06 Civ. 2505 (LAK)), 2006 WL 1128020.
[137] *Id.* at *3.
[138] *Id.*
[139] *Estee Lauder*, 2007 WL 1522620, at *1.
[140] *Id.* at *2 n.5.
[141] *In re* Veeco Instruments, Inc. Sec. Litig., No. 05-MD-01695 (CM)(GAY), 2007 WL 7630569, at *6 (S.D.N.Y. June 28, 2007), *abrogated by* Acticon AG v. China N.E. Petroleum Holdings Ltd., 692 F.3d 34 (2d Cir. 2012).
[142] *Id.* at *7.

to be excluded from the damages calculation.[143] Regarding the shares sold post-disclosure for a profit, the court cited the *Malin* extension of *Dura* with approval and held that shares that could have been sold at a profit to the plaintiff were to be excluded from the damages calculation.[144] The court further noted that if at any point prior to the final calculation of damages the stock price rose above the plaintiff's initial purchase price, that share would be excluded from the damages calculation.[145]

4. *Ross v. Walton* & *In re Immucor, Incorporated Securities Litigation* Apply the *Malin* Rule Outside the Second Circuit

In the 2009 case *Ross v. Walton*, the *Malin* rule was for the first time adopted outside the United States Court of Appeals for the Second Circuit.[146] On January 9, 2007, an indictment against Patrick J. Harrington, Executive Vice President of Business Loan Express ("BLX") was unsealed in a federal district court.[147] Two days later, BLX's parent corporation, Allied, issued a press release disclosing the Harrington indictment.[148] Later that day, Allied's stock fell more than $2 to close at $29.40 per share on ten times its average trading volume.[149] Purchasers of Allied stock subsequently brought a class action against Allied under Section 10(b) and Rule 10b-5.[150]

The *Ross* complaint alleged that Allied failed to disclose that its financial condition was inflated by the reporting of income by BLX, its subsidiary, obtained through the fraudulent loans outlined in the Harrington indictment.[151] In addition, the plaintiffs alleged that the "[d]efendants misrepresented the nature and the scope of the government investigations" into the Allied/BLX

---

143 *Id.*
144 *Id.*
145 *Id.* at *7.
146 668 F. Supp. 2d 32, 42 (D.D.C. 2009) (citing *Malin* and *Estee Lauder* with approval).
147 *Id.* at 35–36.
148 *Id.* at 36.
149 *Id.*
150 *Id.* at 35.
151 *Id.* at 36.

unlawful loan scheme.[152] The complaint alleged the two dollars per share price decline as the plaintiffs' economic loss and that it was caused by disclosure of the Harrington indictment earlier that day.[153]

The defendant moved to dismiss the complaint because, among other alleged defects, the defendant claimed that the plaintiffs had not adequately pleaded economic loss or loss causation.[154] The relevant portion of Allied's motion to dismiss rested on the argument that because Allied stock was trading above the lead plaintiff's purchase price one month before filing of the complaint, the plaintiff did not suffer an actual economic loss.[155]

The court noted that under the traditional out-of-pocket rule and the PSLRA look back provision, a purchaser's loss could be calculated by reference to the amount of overpayment without requiring a sale of the stock.[156] Similar to the *Veeco Instruments* court, Judge Shanstrom recognized that neither United States Supreme Court precedent nor Congressional acts required a 10b-5 plaintiff to sell his stock prior to bringing suit.[157] Nevertheless, the court held that the lead plaintiff had not suffered an economic loss because he could have sold the shares at a profit during June 2007, about six months after the initial disclosure.[158] Judge Shanstrom did not address the possibility that gains six months after the corrective disclosure may be completely unrelated to the fraud or any post-overreaction market correction. Puzzlingly, given the out-of-pocket measure of damages, the court went as far as to say that "[l]ogically, a plaintiff can not

[152] *Ross*, 668 F. Supp. 2d at 36.
[153] *Id.* at 36.
[154] *Id.* at 35.
[155] *Id.* at 42.
[156] *Id.* at 42.
[157] *Id.* at 42.
[158] *Ross,* 668 F. Supp. 2d at 43.

demonstrate the amount the purchaser overpaid if the stock value rose greater than the purchase price on multiple occasions."[159] Consequently, the court dismissed the complaint.[160]

The United States District Court for the Northern District of Georgia also applied the *Malin* rule in *In re Immucor* on a motion to dismiss a 10b-5 complaint.[161] The court correctly restated the *Dura* economic loss standard by providing that "[i]n effect, [the loss causation] element requires the plaintiff to allege that the security's share price 'fell significantly after the truth became known.'"[162] The court nevertheless held that despite post-disclosure price decline, the plaintiff failed to adequately plead economic loss and loss causation because the lead plaintiff could have sold its shares for a profit in the months following the corrective disclosure.[163]

B. *The Southern District of New York's Continuation of the* Malin *Rule in* China North *and the Second Circuit's Reversal in* Acticon

1. *In re China North East Petroleum Holdings Limited Securities Litigation*

On June 11, 2010, purchasers of China North East Petroleum Holdings Limited ("China North") stock filed a class action suit against the company in the United States District Court for the Southern District of New York alleging violations of Section 10b and Rule 10b-5.[164] China North is an American corporation[165] that engages in crude oil extraction in China and produces petroleum.[166] Acticon AG ("Acticon"), the lead plaintiff, alleged that beginning on May 15,

---

159 *Id.* at 43.
160 *Id.* at 44.
161 No. 1:09-CV-2351-TWT, 2011 WL 2619092 (N.D. Ga. June 30, 2011), *reh'g denied*, 2011 WL 3844221 (Aug. 29, 2011).
162 *Id.* at *4. (quoting Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 347 (2005)).
163 *Id.* at *4 (citing *Ross*, 668 F. Supp. 2d at 43).
164 Class Action Complaint at 2, *In re China N.E. Petroleum Holdings Ltd. Securities Litigation*, 819 F. Supp. 2d 351 (S.D.N.Y. 2011) (No. 10 Civ. 4577(MGC)), 2010 WL 2483602.
165 *Id.* at 3.
166 Wall St. Journal, *China N.E. Petroleum Holdings Ltd.*, *Company & People*, WALL ST. J. (last visited Sept. 15, 2012), http://quotes.wsj.com/CNEP/company-people.

2008, China North "misled investors about its reported earnings, oil reserves, and internal controls."[167]

From January 20, 2010, through May 17, 2010, Acticon purchased 60,000 shares of China North for a total of $434,950, an average purchase price of $7.25 per share.[168] Beginning in February 2010, China North made multiple disclosures.[169] On February 23, 2010, China North "announced that it was withdrawing its 2008 and 2009 financial statements."[170] China North then announced on April 15, 2010, "that it was facing delisting by the New York Stock Exchange . . . and that there were certain deficiencies in its internal controls."[171] On April 20, 2010, China North announced "a downward estimate of its earnings and linked its need to do so to its misvaluation of oil and gas properties."[172] China North's stock price declined sharply following each of these disclosures.[173]

The NYSE halted trading of China North's stock on May 25, 2010.[174] Two days later, China North announced that certain managers had resigned for "financial improprieties."[175] During the summer of 2010, the chairman of China North's audit committee announced his resignation because he had concerns about whether China North's 2009 financial statements comported with Generally Accepted Accounting Principles and about whether China North personnel had bribed foreign governmental officials.[176] On September 9, 2010, China North

---

[167] Acticon AG v. China N.E. Petroleum Holdings, Ltd., 692 F.3d 34, 36 (2d Cir. 2012).
[168] *China North*, 819 F. Supp. 2d at 353.
[169] *Acticon*, 692 F.3d at 36.
[170] *Id.* at 36.
[171] *Id.* at 36.
[172] *Id.* at 36.
[173] *Id.* at 36.
[174] *See id.* at 36.
[175] *Acticon*, 692 F.3d at 36.
[176] *Id.* at 36.

stock resumed trading and declined in value approximately twenty percent on very high volume.[177]

On March 22, 2011, China North moved to dismiss the plaintiffs' complaint on the grounds that its allegations did not adequately plead economic loss because, due to a rebound in the share price after China North's final corrective disclosure, Acticon could have sold its stock at a profit.[178] The court correctly noted that, under *Dura*, in addition to price inflation, a 10b-5 plaintiff must allege a post-disclosure decline in share price.[179] The court then pointed out that federal courts have interpreted *Dura* to require, as a matter of law, that a 10b-5 plaintiff does not suffer an economic loss if his stock's post-disclosure price has risen above his purchase price—"even if that price had initially fallen after the corrective disclosure was made."[180] Since there were twelve days in October and November of 2010 when Acticon could have sold at an overall profit, the court held that its unquestionable loss[181] could not be imputed to any of China North's alleged fraud.[182] Consequently, the court dismissed the complaint.[183]

2. *Acticon AG v. China North East Petroleum Holdings Limited*

In hearing Acticon's appeal, the Second Circuit became the first United States Court of Appeals to decide whether an increase in share price to above the plaintiff's average purchase price after the issuer's corrective disclosure precludes an inference that the plaintiff suffered an economic loss attributable to the issuer's alleged misrepresentation.[184] The Second Circuit

[177] *Id.* at 36.
[178] *Id.* at 36–37.
[179] *In re* China N.E. Petroleum Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 352 (S.D.N.Y. 2011).
[180] *Id.* at 352.
[181] Acticon sold its shares for a loss at prices ranging from $3.50 to $6.33 per share between December 2010 and May 2011. *Id.* at 353.
[182] *Id.*
[183] *Id.* at 354.
[184] Wolff, *supra* note 19. Although *Acticon* is a case of first impression, in 1975, the United States Court of Appeals for the Eighth Circuit decided a similar issue using like reasoning. In *Harris v. Am. Inv. Co.*, the plaintiff investor alleged that defendant, AIC, published false and misleading statements that, when corrected, caused him to suffer an

reversed the district court because its holding (as well as the other district courts on which it relied) was inconsistent with the Supreme Court-sanctioned out-of-pocket measure of damages and the congressionally-imposed PSLRA look back provision.[185]

The Second Circuit explained that the district court's holding was flawed because, unlike the out-of-pocket rule, it failed to make the plaintiff whole by allowing recovery of the difference between what the plaintiff paid for the security and its actual worth on the date of purchase.[186] The Second Circuit noted that the *Malin* Court extrapolated the *Dura* holding by equating a post-disclosure price recovery to pre-disclosure price inflation itself, which the Supreme Court had rejected as inadequate to plead economic loss under Rule 10b-5.[187] The Second Circuit disagreed with the *Malin* holding because it equated "two snapshots of the plaintiff's economic situation" without considering intervening events.[188]

The Second Circuit noted that the *Malin* line of cases assumed, without examination, that any intervening losses could be offset by intervening gains.[189] The court opined, however, that offsetting fraudulently-caused losses with completely unrelated gains is improper because,

---

economic loss in violation of § 10b of the Exchange Act and Rule 10b-5. 523 F.2d 220, 222–224 (8th Cir. 1975). The district court granted AIC's motion to dismiss the complaint and held that the plaintiff failed to mitigate his damages because he could have sold for a profit after information correcting the fraud had been disseminated into the market. *Harris v. Am. Inv. Co.*, 378 F. Supp. 894, 900 (E.D. Mo. 1974), *rev'd*, 523 F.2d 220 (8th Cir. 1975). On appeal, the Eighth Circuit noted that under the out-of-pocket measure of damages used in 10b-5 cases, the plaintiff could establish a basis for damages either by presenting evidence that AIC stock was inflated at the time of purchase (this method of establishing economic loss was subsequently abrogated in *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 344 (2005)) or that the price of AIC stock decreased on the date of public discovery of the fraud. Neither method of establishing damages took account of post-disclosure price recovery. The court, pointing to the lack of a common law sell-to-sue requirement in securities fraud actions, held that the plaintiff was not under a duty to sell his stock, "for mitigation of damages or any other purpose," before commencing the action. *Harris*, 523 F.2d at 227. The court noted that it would be unfair to force a long-term investor to sell the securities for the benefit of the defendant. *Id.* at 228. The court further noted that the defendant may not take advantage of any price declines subsequent to the date on which damages are to be assessed—that is, the date on which the general public becomes aware of the fraud—and thus it would be inappropriate to allow the plaintiff to take advantage of subsequent price increases. *Id.*

185 Acticon AG v. China N.E. Petroleum Holdings, Ltd., 692 F.3d 34, 41 (2d Cir. 2012).
186 *Id.*
187 *Id.*
188 *Id.*
189 *Id.*

absent the fraud, the plaintiff would have purchased the uninflated stock *and* benefited from the unrelated gain.[190]

Furthermore, the Second Circuit held that the *Malin* rule was inconsistent with the PSLRA look back provision, which caps the traditional out-of-pocket recovery at the mean price over the ninety days following the final disclosure.[191] The court noted that Congress adopted the look back provision because of the danger that calculating damages based on share price on the day of disclosure may substantially overestimate the plaintiff's damages.[192] The Second Circuit found it compelling that the look back provision, which attempts to limit the plaintiff's damages to those caused by the defendant's fraud, stops well short of the limitation imposed by the *Malin* line of cases.[193]

The Second Circuit decided that Acticon had adequately pleaded economic loss and loss causation under *Dura* because it had alleged an inflated purchase price *and* that China North's share price dropped after the corrective disclosures.[194] The court indicated, however, that later in the litigation the district court would have to determine whether the price rebound was the market's correction to an initial overreaction to the fraud or whether the gains were unrelated.[195] Since at this stage, a relatedness determination was premature, the rebound could not, as a matter of law, negate the inference that the plaintiff had suffered an economic loss.[196] Consequently, the court vacated the district court's decision and remanded the case for further proceedings.[197]

---

[190] *Id.*
[191] *Acticon*, 692 F.3d at 39–41; *In re* Royal Dutch/Shell Trans. Sec. Litig., 404 F. Supp. 2d 605, 609–10 (D.N.J. 2005) (noting that the look back provision is consistent with, and besides the cap, did not otherwise alter, the out of pocket rule).
[192] *Acticon*, 692 F.3d at 39 (quoting S. Rep. No. 104–98, at 20 (1995)).
[193] *Id.* at 41.
[194] *Id.* at 40.
[195] *Id.* at 41.
[196] *Id.*
[197] *Id.* at 40–41.

IV. A Post-Disclosure Rebound Should Not, as a Matter of Law, Negate an Inference of Economic Loss

A. *The* Malin *Rule Imposes an Unjustified De Facto Sell to Sue Requirement Because the Plaintiff's Decision to Sell His Stock Can Instead Be Thought of as a Second Investment Decision*

Courts have generally adopted the notion that a plaintiff is not required to sell his shares prior to bringing suit under Section 10(b) and Rule 10b-5 (i.e., there is no Rule 10b-5 "sell-to-sue" requirement).[198] Even at common law, a defrauded investor was not obligated to sell his securities prior to bringing an action for deceit.[199] Although many of the courts in the *Malin* line of cases expressly recognized that there is no sell-to-sue requirement to bring a Rule 10b-5 claim,[200] their holdings effectively imposed one. Under *Malin*, a rational plaintiff would sell his stock prior to bringing his 10b-5 claim for fear that a price recovery may render his claim moot at any point in the litigation.[201]

A sell-to-sue requirement is, however, logically unnecessary because neither the out-of-pocket measure of damages nor the look back provision takes account of the investor's ultimate sale price. Furthermore, the plaintiff's decision not to sell his stock after disclosure of the fraud can be viewed as a second investment decision, unrelated to his initial investment decision to purchase the stock.[202] The plaintiff could, presumably, usurp the *Malin* rule through a post-

---

[198] *See* Harris v. Am. Inv. Co., 523 F.2d 220, 227 (8th Cir. 1975); Ross v. Walton, 668 F. Supp. 2d 32, 42 (D.D.C. 2009); *In re* Royal Dutch/Shell Tran. Sec. Litig., 404 F. Supp. 2d 605, 610 (D.N.J. 2005); Malin v. XL Capital Ltd., 3:03 CV 2001 PCD, 2005 WL 2146089 (D. Conn. Sept. 1, 2005). *But see* Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970) (same); Cooper v. Garza, 431 F.2d 578 (5th Cir. 1970) (imposing a now abrogated sell-to-sue requirement); Greenstein v. Paul, 400 F.2d 580 (2nd Cir. 1968) (same).

[199] *See* Hindman v. First National Bank, 112 F. 931, 935-36 (6th Cir.), Cert. denied, 186 U.S. 483, 22 S.Ct. 943, 46 L.Ed. 1261 (1902); Hotaling v. A. B. Leach & Co., 247 N.Y. 84, 159 N.E. 870, 872 (1928); Stephens v. Wheeler, 193 Wis. 164, 213 N.W. 464, 468 (1927).

[200] *See*, *e.g.*, *In re* Veeco Instruments, Inc. Sec. Litig., No. 05-MD-01695 (CM)(GAY), 2007 WL 7630569, at *7 (S.D.N.Y. June 28, 2007), *abrogated by* Acticon AG v. China N.E. Petroleum Holdings Ltd., 692 F.3d 34 (2d Cir. 2012); Ross v. Walton, 668 F. Supp. 2d 32, 42 (D.D.C. 2009).

[201] *Malin*, 2005 WL 2146089, at *4.

[202] *See*, *e.g.*, *Harris*, 523 F.2d at 228 (holding that price fluctuations that occur after the plaintiff's second investment decision to hold the stock, unrelated to his first investment decision to purchase the stock, have no bearing on the plaintiff's damages); *Acticon*, 692 F.3d at 41 (quoting *Harris*, 523 F.2d at 228).

disclosure sale of his stock to recognize a loss and then immediate repurchase of the same number of shares on the open market. Thus, it is unfair to force the defrauded, long-term investor to sell his stock for the benefit of the defendant.

B. *Imposing a De Facto Sell to Sue Requirement is Inefficient*

Imposing a de facto sell-to-sue requirement is inefficient because it increases the transaction costs of a long-term investor who preserves his 10b-5 claim through a sale and then immediate repurchase of the same number of shares. This increase in transaction costs is unnecessary because neither the out-of-pocket measure of damages nor the look back provision takes account of the investor's ultimate sale price.[203]

To illustrate, suppose that a fictional court, the United States Court of Appeal for the Fourteenth Circuit, recently held in *Nilam* that plaintiffs who could have sold their stock for a profit after the fraud became known cannot allege the requisite economic loss in a 10b-5 claim. The State of West Dakota is in the Fourteenth Circuit. West Dakota residents, Bob and Steve, both purchase 10,000 shares of ABC Corporation at the fraudulently inflated price of $100 per share. One month later, ABC announces that it has been fraudulently overstating the amount of its oil reserves for the past three years. Immediately following the disclosure, ABC's stock price declines to $75 per share.

Bob thinks that although ABC has made mistakes, it is a tenacious company that will bounce back and eventually enable him to sell at a profit. Bob, however, is a securities litigation lawyer familiar with *Nilam* and knows to sell his shares as soon as possible to preserve his claim in case the stock experiences a quick recovery. Thus, Bob calls his broker Gary and says, "I

---

[203] *See Harris*, 523 F.2d at 226 (citing Esplin v. Hirschi, 402 F.2d 94, 104–05 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969)); *see also* H.R. REP. NO. 104-369, at 42 (1995) (Conf. Rep.) (noting that in a 10b-5 claim, the plaintiff's damages are generally the difference between the price paid for the securities and the price of the securities on the day the public becomes aware of the fraud).

want you to sell my 10,000 shares of ABC and then immediately buy 10,000 shares of ABC." Gary gets out his pocket calculator and realizes that he will make $200 for simply entering the orders.

Such a sale and immediate repurchase, Bob knows, will ensure the preservation of his right to compensation and enable him to take advantage of subsequent gains he expects to occur due to the strength of ABC's other ventures. Gary makes the trades for Bob. At this point, Bob and Steve are in the exact same position regarding their ABC stock purchases, the only difference is that Bob has paid Gary $200 for the claim-preserving trades.

A couple of days later, ABC announces that it has discovered a new oil field in the country of Strakastan. Consequently, ABC stock increases to $101 per share. Two days later, however, communists overrun Strakastan, previously an unstable democracy, and seize ABC's oil field. Upon announcement of ABC's Strakastan misfortune, ABC share price declines sharply to $50 per share, where it remains for the next few years.

Bob files a class action suit against ABC in the United States District Court for the District of West Dakota individually and on behalf of a putative class of ABC investors who purchased ABC stock between the time that ABC first began overstating its oil reserve figures and the date of the corrective disclosure. The class action complaint alleged violations of Section 10 of the Exchange Act and Rule 10b-5.

A short time later, Steve receives a form letter from Bob's law firm notifying him of the impending litigation and asking if he would like to join the suit. Steve acquiesces. *Bob v. ABC* is assigned to Judge Flakowitz. ABC files a 10(b)(6) motion to dismiss for failure to state a claim upon which relief can be granted. ABC argues that, under *Nilam*, because many ABC investors could have sold at a profit during the two post-corrective disclosure days immediately following discovery of the Strakastan oil field, the complaint should be dismissed for failure to plead economic loss. Judge Flakowitz examines the relevant documents and notices that the class members could be placed into three categories: (1) those who sold before the brief recovery and did not rebuy, (2) those who sold before the brief recovery and immediately rebought (Bob was the only one), and (3) those who held their shares all the way through the price recovery to the further decline.

In his decision, Judge Flakowitz first notes that the PSLRA look back provision is not implicated in this case due to the brevity of the post-disclosure recovery. Judge Flakowitz denies ABC's motion to dismiss as to all category one plaintiffs. Then, citing *Nilam*, Judge Flakowitz dismisses all category three class members including Steve because they could have sold their shares at a profit following the corrective disclosure. Furthermore, Judge Flakowitz holds that because Bob sold his shares, recognized a loss, and then made a second investment decision to purchase ABC shares on the open market, he adequately alleged economic loss and causation.

After a brief trial, a jury finds for the plaintiffs. Damages were calculated using the commonly accepted out of pocket rule. For example, in calculating Bob's damages the Court took the difference between what Bob paid for his stock and what his stock was worth following the disclosure. Thus, Bob's damages were 100 – 75 = $25 per share. At no point in the entire litigation, except for on the motion to dismiss, was Bob's sale price relevant. The only parties that benefited from Judge Flakowitz's partial grant of ABC's motion to dismiss were the ABC corporation, who had intentionally deceived the investing public, and Bob's broker, Gary, who made $200 for entering two orders necessitated only by the irrational *Nilam* decision.

Notice that if ABC had never fraudulently overstated the amount of its oil reserves, Bob and Steve's purchase price would have been around $75. ABC shareholders still would have benefited from unrelated gains such as the stock appreciation caused by the discovery of oil in Strakastan. Because the $25 depreciation represents the actual reduction in the present value of ABC's future cash flows, rather than merely a market overreaction, it is gone forever. Subsequent unrelated appreciation in the value of the stock should not be considered compensation to the shareholders; rather, it is profit that ABC shareholders were entitled to receive, completely independent of the fraud, due to their investment in ABC stock. To deprive ABC shareholders of these gains, which they experienced by risking their money through retention of ABC stock, by renaming it "compensation" is unjust and intolerable.

C. *The Policy Consideration Espoused by the Supreme Court in* Dura *Does Not Support the* Malin *Rule*

The *Dura* Court explained that at the time of the initial purchase, any fraudulent price inflation is offset by the fact that the investor owns a highly liquid security that is worth the inflated price.[204] At first glance, when taken out of context, it may seem as though the same is true of a share that has fully recovered after an initial post-disclosure depreciation.[205] Upon further inspection, however, it becomes clear that the *Dura* Court sought simply to enforce the requirement that a 10b-5 plaintiff plead and prove a consequent economic loss.

The *Dura* Court held mere allegations of price inflation insufficient to plead economic loss because the stock the investor holds right after purchase is still worth the inflated price, and the investor may never experience a consequent depreciation.[206] According to the Court, the investor may not experience a consequent depreciation because he may sell his shares prior to

[204] Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342 (2005).
[205] *See, e.g.*, Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089, *4 (D. Conn. Sept. 1, 2005), *abrogated by* Acticon AG v. China N.E. Petroleum Holdings Ltd., 692 F.3d 34 (2d Cir. 2012) (holding that a share that had increased to above its pre-disclosure value is functionally equivalent to an inflated share price that never lost value).
[206] *Dura*, 544 U.S. at 342.

disclosure,[207] or any subsequent depreciation may be caused by events unrelated to the alleged misrepresentation.[208]

a. The Double Damages Predicament

In the case of the investor who sells prior to disclosure, although he may have been defrauded into paying more for his shares than they were worth, to allow him to recover would force the defendant to pay double damages for those shares. To see why, suppose that Jack buys fraudulently inflated XYZ Corporation stock. Then, prior to XYZ's disclosure of their fraudulent conduct, Jack sells his XYZ stock to Clementine. A few days after the sale, XYZ reveals that it's been misrepresenting the likelihood of FDA approval of its novel cancer drug. XYZ stock declines sharply immediately following the disclosure. Although it is likely that Clementine has a legitimate 10b-5 claim against XYZ, does Jack?

To allow Jack to recover even though the furthest his economic loss allegations go is his inflated purchase price would force XYZ to pay damages twice on the same shares, once to Jack and once to Clementine. Conversely, allowing a plaintiff who has experienced a post-disclosure price decline and then a subsequent unrelated price rebound does not present a double damages predicament because the plaintiff must own the stock at the time of disclosure and depreciation.

b. Solely Unrelated Declines After an Alleged Corrective Disclosure Signal Immateriality or Else Prior Disclosure

In the case of a plaintiff whose post-disclosure share price decline is attributable only to unrelated events, the misrepresentation was either not material or already known to the public, and thus the fraud is not what caused the depreciation. Since materiality and causation are elements of a 10b-5 claim,[209] the *Dura* Court was correct in asserting unrelated, post-disclosure

[207] *Id.* at 342.
[208] *Id.* at 342–43
[209] *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 157.

share depreciation as an example of when allowing recovery in a 10b-5 case would be inappropriate.

Thus, ownership of a post-disclosure share that has rebounded due to unrelated events does not offset the fact that the plaintiff was sold stock at a fraudulently inflated price in the same manner that a pre-disclosure inflated share price does. As the *Dura* court pointed out, absent the fraud, the plaintiff would have purchased the stock at an uninflated price *and* benefited from the subsequent, unrelated gain.

V. CONCLUSION

Courts require a 10b-5 plaintiff's damages to be causally related to the defendant's fraud. Put differently, a 10b-5 plaintiff does not benefit from post-disclosure price depreciation that is unrelated to the fraud. Why then should an unrelated, post-disclosure price recovery benefit the defendant?

Market price is essentially a reflection of the present value of the future cash flows to which the shareholder is entitled. When a corporation discloses that it made a material misrepresentation, the expected value of the future cash flows decreases, and thus the present value of the stock depreciates. Subsequent appreciation in the value of the stock may be the result of an expected increase in future cash flows due to unrelated circumstances, or it may be the result of the market realizing that the fraud will not have as big of an impact on future cash flows as previously thought. The portion of depreciation in the stock that correctly reflects the decrease in the expected cash flows caused by revelation of the fraud, as opposed to a market overreaction, represents actual economic loss. Subsequent unrelated appreciations do not compensate the investor for these losses, because absent the fraud, the stock would have retained its value, and the shareholder would have benefited from the unrelated gain.

Instead of the *Malin* rule, trial courts should require the plaintiff to prove that post-disclosure depreciations were caused by revelations of the defendant's fraud. Given the complexity of financial markets, this may seem like an arduous task, but if the stock price drops on high volume immediately following disclosure there can be little doubt as to its genesis. Once the plaintiff has carried his burden of proving that losses were caused by the defendant's fraud, the burden should shift to the defendant to prove that subsequent gains were related and should offset the plaintiff's damages, dollar for dollar. This analysis is much more difficult but should consider factors such as the amount of time that has elapsed since disclosure (i.e., the more time that has elapsed, the more likely it is that gains are unrelated),[210] and whether there are other circumstances that have surfaced since disclosure that would tend to cause the stock to appreciate (other revelations and events indicate that the gain is unrelated).

Holding that post-disclosure appreciation to above the plaintiff's purchase price precludes economic loss as a matter of law works an injustice on the 10b-5 plaintiff and benefits the corporations that engage in fraudulent behavior. As such, the *Malin* rule should be overruled throughout the United States and replaced with a standard that strives to determine what loss was caused by the fraud and what loss what caused by market overreaction. Though this task may prove difficult, imprecision in the damages award is still better than denying victims of corporate fraud compensation for their real and irretrievable losses.

[210] *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 343 (2005).