A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")

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INTRODUCTION

To recover damages in a private cause of action under Securities and Exchange Commission Rule 10b-5 of the Securities Exchange Act of 1934 ("1934 Act"), a plaintiff must plead and prove "loss causation." While circuits agree that loss causation refers to the causal nexus between a plaintiff's injury and a defendant's wrongful conduct, they disagree on how direct the connection must be. How a court specifically defines loss causation is critical because it directly affects the extent of a plaintiff's burden of proof. Thus, a court's view on loss causation can ultimately be the principal determinant in assessing a defendant's liability.

The loss causation controversy can be traced back to loss causation's unstable foundation. Loss causation developed exclusively out of case law and was never expressly recognized by the Supreme Court. Consequently, courts formulated different
approaches to loss causation without any source of uniform guidance.\textsuperscript{9} The majority of courts adopted a narrow view of loss causation. Under the majority view, a plaintiff who uses post-transaction investment value to measure recoverable loss must establish a connection between the post-transaction investment value and the defendant's fraud. For example, suppose investor A purchases stock in XYZ Company on day 1 and on day 5 the price of XYZ Company stock drops. Next, suppose that investor A sues XYZ Company pursuant to Rule 10b-5 in an attempt to recover for the decline in the value of the stock. A majority-view jurisdiction would require investor A to establish a connection between XYZ Company's fraud and the drop in the stock price on day 5.\textsuperscript{10} The direct causation approach, the foreseeability approach, and the materialization-of-the-risk approach all adhere to the majority view.

The some-causal-nexus approach, on the other hand, complies with the minority view, which defines loss causation in broader terms. Under the minority view, a plaintiff who uses post-transaction investment value to measure recoverable loss does not necessarily have to link the defendant's fraud to the post-transaction investment value. The plaintiff can establish loss causation by simply demonstrating that the defendant's fraud was in some way responsible for artificially altering the transaction price. For example, in the above illustration, a minority-view jurisdiction would allow investor A to establish loss causation by showing that on day 1 the price of XYZ Company stock was artificially inflated because of XYZ Company's fraud.\textsuperscript{11} Thus, proving loss causation is easier for plaintiffs in minority-view jurisdictions.

In December 1995, loss causation was finally considered by a central authority when Congress enacted the Private Securities Litigation Reform Act of 1995 (the "PSLRA").\textsuperscript{12} Section 101(b)\textsuperscript{13} of the PSLRA codified loss causation by adding section 21D(b)(4)\textsuperscript{14} to the 1934 Act. Section 21D(b)(4) provides that the plaintiff has the...
burden of proving loss causation for all private actions arising out of section 10(b)\textsuperscript{15} of the 1934 Act.\textsuperscript{16} Although the PSLRA does not clearly delineate the boundaries of loss causation or expressly provide courts with a model approach to loss causation, it does subject courts to a central loss causation rule.\textsuperscript{17}

Part I of this Note traces the historical development of Rule 10b-5 and outlines the essential elements in a Rule 10b-5 cause of action. Part II explores loss causation’s origin, examines Supreme Court jurisprudence that touches on issues of causation, and sets forth a detailed description of the various loss causation approaches. Part III delves into the legislative history of the PSLRA and discusses the Congressional rationale for creating the Act. Part IV critiques the various loss causation approaches and argues that courts should settle their differences in favor of the materialization-of-the-risk approach, which this Note considers the winning approach to loss causation.\textsuperscript{18}

I. BACKGROUND

Because courts are divided on how to approach loss causation in a private cause of action brought pursuant to Rule 10b-5, it is beneficial to begin loss causation analysis with a general overview of Rule 10b-5. This part provides such an overview by examining the evolution of Rule 10b-5\textsuperscript{19} and describing the essential elements in a Rule 10b-5 private cause of action.\textsuperscript{20}

A. Historical Overview of Rule 10b-5

Congress passed both the Securities Act of 1933 (the “1933 Act”)\textsuperscript{21} and the Securities Exchange Act of 1934 (the “1934 Act”)\textsuperscript{22} in response to the 1929 stock market crash.\textsuperscript{23} Congressional investigations subsequent to the 1929 crash revealed that a variety of

\textsuperscript{15}See 15 U.S.C. § 78j(b) (1994); infra note 29 and accompanying text.
\textsuperscript{17}See infra Part III.
\textsuperscript{18}See infra Part IV.
\textsuperscript{19}See infra Part I.A.
\textsuperscript{20}See infra Part I.B.
\textsuperscript{22}See id. §§ 78a-78ll.
\textsuperscript{23}See Hazen, supra note 1, at 7.
manipulative and deceptive trading practices existed in the securities market prior to the crash, which significantly contributed to the market’s collapse.24 Thus, reform was necessary to prevent future market disasters, restore investor confidence in the market, and rejuvenate the economy.25

To achieve these purposes, Congress drafted the 1933 and 1934 Acts. Both acts contained provisions designed to improve the accuracy of securities information and deter fraud.26 The 1933 Act primarily concentrated on the distribution of securities.27 The 1934 Act was a broader and more “omnibus regulation” that increased investor protections and significantly extended the scope of the 1933 Act.28 The general antifraud provision of the 1934 Act can be found in section 10(b), which states:

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.29

Essentially, section 10(b) makes it unlawful for persons to use “manipulative or deceptive” practices “in connection with the purchase or sale of” securities in violation of rules promulgated by the “Commission.”30 The “Commission” is the Securities and Exchange Commission (the “SEC”), which Congress established in conjunction with the 1934 Act.31

In 1942, pursuant to its authority under section 10(b), the SEC promulgated Rule 10b-5 to further combat securities fraud.32 Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the

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25. See Millisor, supra note 8, at 627.
26. See Hazen, supra note 1, at 7.
27. See id.
28. Id. at 7-8. Unlike the 1933 Act, the 1934 Act regulates all aspects of public securities trading, covers both the purchasers and sellers of securities, and sets forth registration and reporting requirements for the issuers of securities. See id. at 8.
30. Id.
31. See Hazen, supra note 1, at 7-8.
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 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. 33

Thus, the SEC designed Rule 10b-5 to eliminate: (1) fraudulent
schemes, (2) material misstatements, (3) material omissions where a
duty to disclose exists, and (4) fraudulent acts. 34

In creating Rule 10b-5, the SEC constructed “a powerful antifraud
weapon” 35 that has become “[t]he principal tool for promoting the
informational integrity of securities transactions.” 36 Rule 10b-5
broadened the scope of the SEC’s enforcement authority in public
actions 37 and has become the principal means used by private
investors to recover for fraudulent misconduct in private actions. 38
Although the rule did not expressly give investors a right to a private
remedy, in 1946 a federal district court held that a private cause of
action could be implied from the rule. 39 Other districts and circuits
followed that holding. Twenty-four years later, the Supreme Court
formally upheld an implied private right of action in Superintendent of
Insurance v. Bankers Life & Casualty Co. 40

B. The Requisite Elements in a Rule 10b-5 Private Cause of Action

As use of the Rule 10b-5 private cause of action increased, it
became necessary for courts to formulate the specific requirements
and limitations of the Rule. Because a statute expressly outlining the
private cause of action did not exist, courts turned to common law tort
principles for guidance. 41 Applying general common law principles to
a wide variety of securities transactions was a difficult endeavor and
created a great deal of ambiguity and uncertainty. 42 As a result, courts

34. See id.
35. Hazen, supra note 1, at 669.
36. Cox et al., supra note 32, at 681.
37. See id. at 681-82. Because Rule 10b-5 can be used against both the buyers and
sellers of securities, it eliminated a loophole created by section 17(a) of the 1933 Act,
15 U.S.C. § 77q (1994), which can only be used to combat fraud in connection with the
sale of securities. See id.
38. See Millisor supra note 8, at 628.
40. 404 U.S. 6, 13 & n.9 (1971).
41. See Herzog, supra note 7, at 360.
42. See Kaufman, Material World, supra note 8, at 1-3; Millisor, supra note 8, at
628-29.
subjected the Rule 10b-5 private action to constant revision.\textsuperscript{43} Although the Supreme Court recognized "a judicial authority to shape, within limits, the 10b-5 cause of action,"\textsuperscript{44} the Court addressed only certain Rule 10b-5 issues and never explicitly defined all of the requisite elements in a Rule 10b-5 private action.\textsuperscript{45} Nevertheless, all courts agree that a plaintiff bringing a private cause of action under Rule 10b-5 must allege: (1) that the defendant, "in connection with the purchase or sale of any security," (2) made a material misstatement (or material omission where a duty to disclose exists) (3) with scienter (4) that was justifiably relied on by the plaintiff (5) and caused (6) the plaintiff to suffer damages.\textsuperscript{46}

Because knowledge of all of the requisite elements in a Rule 10b-5 private cause of action is helpful in understanding how courts have addressed loss causation, this section sets forth a brief description of each of the elements.

1. "In connection with the purchase or sale of any security"

A plaintiff asserting a Rule 10b-5 claim for securities fraud must first demonstrate that the injury occurred "in connection with the purchase or sale of any security."\textsuperscript{48} This is a statutory requirement

\textsuperscript{43} See Kaufman, \textit{Material World}, supra note 8, at 1; Millisor, \textit{supra} note 8, at 628-29.

\textsuperscript{44} Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 293 (1993).

\textsuperscript{45} See Kaufman, \textit{Material World}, \textit{supra} note 8, at 1-2; Millisor, \textit{supra} note 8, at 628-29. Furthermore, the Court has never even mentioned the terms "loss causation" or "transaction causation." See \textit{supra} note 8 and accompanying text.

\textsuperscript{46} See, e.g., Gasner v. Board of Supervisors, 103 F.3d 351, 356 (4th Cir. 1996) (noting the elements that a plaintiff must prove in a Rule 10b-5 private cause of action); see also John Kanberg & Tanya Herrera, \textit{Potential Liabilities in Initial Public Offerings, in 1 Securities Arbitration} 1998, at 251, 280-84 (FLI Corp. Law & Practice Course Handbook Series No. B-1061, 1998) (outlining the elements of a plaintiff's burden of proof in a Rule 10b-5 private cause of action). In a private cause of action for material omissions, the plaintiff would have the added burden of proving that the defendant had a duty to disclose. See Kanberg & Herrera, \textit{supra}, at 283-84. Additionally, some of the requisite elements in a Rule 10b-5 private cause of action are not requisite elements in an SEC enforcement action. See, e.g., SEC v. Rana Research, Inc., 8 F.3d 1358, 1364 (9th Cir. 1993) (agreeing with the Sixth and Second Circuits that reliance is not a requisite element in an SEC enforcement action); SEC v. Hasho, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992) (stating that establishing liability in a Rule 10b-5 enforcement action requires the SEC to prove that the defendant used jurisdictional means to make a material misstatement or omission with scienter in connection with the purchase or sale of a security).

\textsuperscript{47} Examining all of the elements is also helpful because resolving the loss causation controversy not only requires an understanding of loss causation, which falls under the general element of causation, but also an understanding of damages. See \textit{infra} notes 336-41 and accompanying text.

\textsuperscript{48} 17 C.F.R. § 240.10b-5 (1998); \textit{supra} note 33 and accompanying text; see also \textit{supra} note 46 and accompanying text (listing the requisite elements in a Rule 10b-5 private action).
that arises directly from the text of Rule 10b-5. The Supreme Court has interpreted the “in connection with” element broadly, holding that a plaintiff can satisfy the element by simply demonstrating that “deceptive practices touch[ed]” the securities transaction. The Supreme Court has also held that only a defrauded purchaser or seller of securities has standing to bring a private cause of action pursuant to Rule 10b-5 due to the phrase “purchase or sale” in the rule’s text.

Since the Court’s holding, the lower federal courts have recognized that Rule 10b-5 affords protection to such purchasers as: (1) shareholders in shareholder derivative suits; (2) trust beneficiaries; (3) corporations in merger transactions; (4) pledgors of securities; (5) pledgees of securities; (6) record owners of securities; and (7) equitable owners of securities. Thus, courts have adopted a flexible approach to the purchaser/seller standing requirement of Rule 10b-5.49

49. See 17 C.F.R. § 240.10b-5; supra note 33 and accompanying text.


51. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-49 (1975) (adopting the ruling in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952)).

52. See, e.g., Ray v. Karris, 780 F.2d 636, 641 (7th Cir. 1985) (noting that a shareholder’s right to sue derivatively under Rule 10b-5 was established in Dashor v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967)).

53. See, e.g., Hackford v. First Sec. Bank of Utah, N.A., 521 F. Supp. 541, 549 (D. Utah 1981) (finding that trust beneficiaries had standing to bring a private action under Rule 10b-5 because they had a beneficial interest in the stock sold and were not mere bystanders), aff’d, No. 81-1863, 1983 WL 20180 (10th Cir. Jan. 31, 1983).

54. See, e.g., Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240, 243 (D. Neb. 1972) (stating that for purposes of section 10b, courts have held that a merger involves a “purchase” or “sale”), aff’d, 473 F.2d 537 (8th Cir. 1973).

55. See, e.g., Madison Consultants v. FDIC, 710 F.2d 57, 60-61 (2d Cir. 1983) (holding that the plaintiffs, who were pledgors of stock, had standing to sue under Rule 10b-5 because Rule 10b-5 should be read flexibly).

56. See, e.g., Mallis v. FDIC, 568 F.2d 824, 829-30 (2d Cir. 1977) (holding that pledgors of securities have standing to sue under Rule 10b-5 because pledgors assume a real investment risk in the pledged securities). But see, e.g., National Bank of Commerce v. All American Assurance Co., 583 F.2d 1295, 1299-1300 (5th Cir. 1978) (ruling that pledgors of securities do not constitute purchasers or sellers of securities for purposes of Rule 10b-5 because pledgors have remedies on the note itself and thus do not need the protection of the federal securities acts).

57. See, e.g., Goldstein v. Cytogen Corp., Civ. No. 92-3960 (CSF), 1993 WL 274246, at *1-*5 (D. N.J. June 7, 1993) (granting class certification to record owners of common stock who had filed a class action pursuant to Rule 10b-5).

58. See, e.g., Mullen v. Sweetwater Dev. Corp., 619 F. Supp. 809, 814-16 (D. Colo. 1985) (concluding that the plaintiffs, as equitable interest holders in the stock, had standing to bring a private action under Rule 10b-5).

59. Courts have even created a number of exceptions for plaintiffs who do not directly qualify as purchasers or sellers of securities. For example, the “aborted seller” rule would allow a Rule 10b-5 cause of action to be brought against a would-be purchaser of securities. See Hazen, supra note 1, at 677. Some courts also allow injunctive relief under Rule 10b-5 regardless of whether the person seeking equitable relief was a purchaser or seller of securities. See id. at 678-79. Additionally, under certain circumstances, courts have considered the participants in transactions involving contract rights or option contracts as purchasers or holders of securities. See id. at 680-82.
2. Materiality

A Rule 10b-5 plaintiff must also prove that the defendant's fraudulent misconduct was material.60 In a leading Rule 10b-5 case, the Second Circuit clarified the meaning of materiality by looking to the Restatement of Torts, which defined materiality in terms of whether a reasonable person would have considered the misrepresented fact an important factor when determining his course of conduct with respect to the transaction.61 Since then, the Supreme Court has ruled that under Rule 10b-5 "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information."62 Thus, materiality requires a highly factual inquiry and can be difficult to predict.63

3. Scienter

Another element that a plaintiff must satisfy is scienter.64 Influenced by the legislative history and text of both section 10(b) and Rule 10b-5, the Court in Ernst & Ernst v. Hochfelder65 resolved twenty years of conflicting cases by holding that Rule 10b-5 requires a plaintiff to prove that the defendant acted with scienter.66 The Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud,"67 and it opined that the drafters of section 10(b) embraced the scienter element because the words "any manipulative or deceptive device or contrivance" suggest that section 10(b) was intended to proscribe only intentional misconduct.68 Since then, the Court has also ruled that the scienter requirement applies to SEC enforcement actions.69 No Supreme Court case, however, has addressed whether a plaintiff can establish scienter by showing reckless conduct.70 As a result, federal courts have developed

60. See 17 C.F.R. § 240.10b-5 (1998); supra note 33 and accompanying text; see also supra note 46 and accompanying text (listing the requisite elements in a Rule 10b-5 private action).
62. Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988); see also infra notes 134-44 and accompanying text (discussing Basic). In Basic the Supreme Court applied the test it developed in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976). See Basic, 485 U.S. at 238-40. In TSC the Supreme Court held that under Rule 14a-9 "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." TSC, 426 U.S. at 449.
63. See Hazen, supra note 1, at 693.
64. See supra note 46 and accompanying text.
66. See id. at 193-214; see also Hazen, supra note 1, at 683 (noting that after twenty years of conflicting cases, the Supreme Court defined scienter in Ernst).
68. Id. at 195 (quoting 15 U.S.C. § 78j(b) (1994) (internal quotations omitted)).
69. See Aaron v. SEC, 446 U.S. 680, 691-95 (1980).
70. See Hazen, supra note 1, at 685. Under certain circumstances, recklessness
different rules on the specificity requirements for pleading scienter. 71

4. Reliance

A plaintiff must also demonstrate that he justifiably relied on the defendant’s fraudulent misconduct. 72 For many years, lower courts have applied the common law fraud test of reliance to Rule 10b-5 private actions. 73 The common law fraud test requires a plaintiff to prove that the defendant’s fraud was a substantial factor in determining the course of conduct that resulted in the plaintiff’s loss. 74 Although the Supreme Court has agreed with lower courts “that reliance is an element of a Rule 10b-5 cause of action,” 75 it has also held that positive proof of reliance is not a prerequisite to recovery in cases involving fraudulent omissions or fraud on the market. 76 Thus, unless a case falls into one of those two categories, the plaintiff has the burden of proving reliance.

constitutes scienter in a common law action for fraud or deceit. See id. at 685 & n.14.


72. See supra note 46 and accompanying text.

73. See, e.g., List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir. 1965) (setting forth the test for reliance in a Rule 10b-5 private action based on the common law fraud test as defined in the Restatement (First) of Torts § 546 (1938)).

74. See id.

75. Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988); see also infra notes 134-44 and accompanying text (discussing Basic).

76. See id. at 247 (holding that a rebuttable presumption of reliance exists in fraud-on-the-market cases because investors who buy or sell securities at the market price rely on the integrity of that price); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 152-54 (1972) (ruling that proof of reliance is not required in fraudulent omissions cases because in such cases proof of materiality sufficiently establishes causation in fact). For a more detailed discussion of Basic, see infra Part II.B.
5. Causation

To satisfy the element of causation, a plaintiff must prove both transaction and loss causation. Courts have defined transaction causation as the causal connection between a defendant's fraud and a plaintiff's engagement in the transaction in question. Some courts have also characterized transaction causation as a form of "but for" causation. Although a plaintiff can establish transaction causation by proving that the transaction would not have occurred but for the defendant's fraud, transaction causation only requires a plaintiff to demonstrate that the defendant's fraudulent misconduct affected the terms of the resulting transaction. Generally, courts have taken a broad approach to transaction causation and some courts have even stated that it is "merely another way of describing reliance."

Loss causation, on the other hand, which courts have defined as the causal connection between a defendant's fraud and a plaintiff's injury, is the source of much controversy and confusion. While some courts view loss causation as a form of proximate causation and utilize traditional proximate causation tests in loss causation analyses, other courts have adopted a broader approach to loss causation and allow the loss causation requirement to be satisfied by proof of "some causal nexus" between a plaintiff's pecuniary loss and a defendant's fraudulent misconduct. Thus, the burden that a plaintiff must overcome to satisfy loss causation varies with each jurisdiction.

6. Damages

Under Rule 10b-5, a plaintiff's recovery is limited to actual damages. To assess actual damages, courts have adopted three
different approaches: (1) the benefit-of-the-bargain method; (2) rescission; and (3) the out-of-pocket rule. The benefit-of-the-bargain method is essentially a contract remedy that is based on breach of promise. Some courts have permitted benefit-of-the-bargain damages in the broker/customer context, and at least one court has adopted the benefit-of-the-bargain method in a tender offer case. Rescission, on the other hand, is typically reserved for cases involving fraud in the inducement, where the plaintiff seeks to be restored to the status quo. Lastly, the out-of-pocket rule is commonly used in cases where the defendant's fraud artificially altered the value of the plaintiff's investment. The out-of-pocket rule has traditionally been the most commonly used approach in Rule 10b-5 private actions.

Under the out-of-pocket rule, damages are based on the difference between the transaction price and the actual value of the security at the time of the transaction. The Supreme Court, however, has never endorsed a specific methodology for calculating out-of-pocket damages, and as a result experts have utilized two different approaches to determine the “value line” against which a company's actual stock price is compared. The “constant ribbon,” or “price reaction,” method measures the difference between the stock price prior to the “curative disclosure” and the stock price subsequent to

10b-5 action unless the plaintiff brings a common law fraud claim in the same action pursuant to the doctrine of pendant jurisdiction. See id.

87. See Hazen, supra note 1, at 714-16.
88. See id. at 715.
90. See Osofsky v. Zipf, 645 F.2d 107, 114 (2d Cir. 1981) (stating that “the benefit-of-the-bargain rule should be applied under the 1934 Act to the limited situation... where misrepresentation is made in the tender offer and proxy solicitation materials as to the consideration to be forthcoming upon an intended merger”), appeal after remand 725 F.2d 1057 (2d Cir. 1984).
91. Fraud in the inducement cases are cases in which the plaintiff “would not have entered into the transaction but for the defendant’s fraud.” Hazen, supra note 1, at 715.
93. See Hazen, supra note 1, at 715-16.
95. See Kaufman, Damages, supra note 94, § 1B:07, at 13.
96. The value line is the price that a stock would have been over a period of time if there had been no fraud.
97. See Dickey & Mayer, supra note 94, at 1203-04; Kaufman, Damages, supra note 94, § 1B:07, at 14.
98. Curative disclosure refers to the time at which the market is informed of the fraud.
the “curative disclosure.”\textsuperscript{99} This method only permits recovery by plaintiffs who purchased and retained shares during the class period.\textsuperscript{100} The “constant true value method,” on the other hand, calculates the difference between the price paid for the stock and the true value of the stock.\textsuperscript{101} The true value of the stock for the entire class period is presumed to be the price of the stock following the “curative disclosure.”\textsuperscript{102} Under the “constant true value method,” it is possible for “in and out”\textsuperscript{103} investors to recover.

In response to the uncertainties and complexities involved in damage calculations under Rule 10b-5, Congress added section 21D(e)\textsuperscript{105} to the 1934 Act via the PSLRA.\textsuperscript{106} Generally, section 21D(e) limits damages in certain securities cases to the difference between the purchase price paid for the security and the mean trading price of that security during a ninety-day look-back period.\textsuperscript{107} Section 21D(e) does not replace or endorse any of the damage calculation methods or rules.\textsuperscript{108} Rather, it limits recovery under those various methods and rules.\textsuperscript{109} Although Congress intended section 21D(e) to reduce the overestimation of plaintiffs’ damages in certain securities cases,\textsuperscript{110} a number of scholars have asserted that due to certain ambiguities contained in section 21D(e), the new provision “will have, at most, a modest impact in . . . future cases.”\textsuperscript{111}

Because Rule 10b-5 is a powerful antifraud weapon that enables private investors to recover for securities fraud, ambiguity as to the elements of a Rule 10b-5 action can have serious financial

\textsuperscript{99} See Kaufman, Damages, supra note 94, § 1B:07, at 14-15. For example, “if an investor buys at $20 a share and the stock appreciates to $25 but then goes to $15 a share after a disclosure . . . . Under the constant ribbon method, value as measured by the price reaction is $10 [(25 - 15 = 10)].” Id. § 1B:07, at 15.

\textsuperscript{100} See id. § 1B:07, at 14-15.

\textsuperscript{101} See id. § 1B:07, at 15.

\textsuperscript{102} See id. For example, “if an investor buys at $20 a share and the stock appreciates to $25 but then goes to $15 a share after a disclosure, under the constant true value model, the damages are the difference between the price paid and the true value ($20 - 15 = 5).” Id.

\textsuperscript{103} “In and out” investors are investors who sold their stock prior to the curative disclosure.

\textsuperscript{104} Kaufman, Damages, supra note 94, § 1B:07, at 15.


\textsuperscript{107} See 15 U.S.C. § 78u-4(e) (Supp. 1997); infra note 336 and accompanying text.

\textsuperscript{108} See Kaufman, Damages, supra note 94, § 1B:07, at 18.

\textsuperscript{109} See id. For an example of how section 21D(e) would limit recovery under both the “constant ribbon method” and “constant true value method,” see id., § 1B:07, at 15-16.

\textsuperscript{110} See supra note 106.

\textsuperscript{111} Dickey & Mayer, supra note 94, at 1219; see also Kaufman, Damages, supra note 94, § 1B:07, at 14 (quoting Dickey & Mayer, supra note 94, at 1219).
consequences. Arriving at a cohesive and uniform approach to loss causation would therefore further the goals of securities laws in protecting investors and punishing fraudulent acts. The next part discusses the historical development of loss causation and illustrates how various courts have approached its analysis.

II. LOSS CAUSATION

This part reviews the origin of loss causation and investigates Supreme Court jurisprudence touching on causation and related issues. It then explores in detail the federal case law on loss causation and sets forth the analytical intricacies involved in the various loss causation approaches.

A. The Origin of Loss Causation

_Schlick v. Penn-Dixie Cement Corp._112 was the first case to ever make a distinction between transaction causation and loss causation.113 Prior to _Schlick_, courts had satisfied principals of causation through the element of reliance,114 which was directly in line with notions of common law fraud.115 In _Schlick_, the plaintiff, who owned stock in Continental Cement Corporation, argued that Penn-Dixie's fraud caused him to receive a less favorable exchange ratio when a merger was effectuated between Penn-Dixie and Continental.116 Penn-Dixie contended that because the plaintiff was a minority shareholder, he could not have prevented the merger, and thus could not have relied on the misrepresentation.117 The court disagreed and articulated its reasoning by dividing its causation analysis into two parts: "loss causation" and "transaction causation."118 The court defined loss causation as the causal connection between the defendant's fraud and the plaintiff's injury,119 and transaction causation as the causal connection between the defendant's fraud and the plaintiff's engagement in the transaction in question.120 The court then stated that loss causation was "demonstrated rather easily, by proof of some form of economic damage, here the unfair exchange ratio."121 The

112. 507 F.2d 374 (2d Cir. 1974).
113. See id. at 380-81; see also Kaufman, Exposing Fraud, supra note 6, at 360-61 (discussing Schlick).
114. See, e.g., List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir. 1965) (stating that reliance should be required because in a Rule 10b-5 private action causation-in-fact is a basic element of tort law).
115. See Restatement (First) of Torts § 546 (1938); William L. Prosser, Law of Torts § 89, at 550 (Hornbook Series, 2d ed. 1955).
116. See Schlick, 507 F.2d at 376.
117. See id. at 382.
118. Id. at 380-81.
119. See id. at 380.
120. See id.
121. Id.
court further posited that transaction causation was unnecessary in cases where the plaintiff alleges “market manipulation and a merger on preferential terms.”122 Ironically, the court’s desire to clarify ambiguity surrounding transaction causation created the even more confusing element of loss causation.

After Schlick, courts gradually began to incorporate loss causation into the framework of Rule 10b-5 analyses. But recognition of the element did not come without its difficulties. Courts have referred to loss causation as “ungainly, exotic, confusing, and even unhappy.”123 One reason for the turmoil surrounding loss causation is that many courts have viewed it as a form of proximate cause,124 an area of common law torts that has historically induced a great deal of debate.125 Furthermore, common law fraud cases have typically examined causation through the element of reliance and have not directly required plaintiffs to address proximate cause concerns.126 Only common law negligence cases have clearly distinguished between cause in fact (“but for”) and legal cause (“proximate”).127 Thus, by dividing causation analysis into loss causation and transaction causation, courts have adopted an approach more similar to the one used in common law negligence cases. This tends to be confusing because a Rule 10b-5 cause of action is an action against securities fraud, which is more akin to common law fraud.128

B. Supreme Court Jurisprudence

Although the Supreme Court has never explicitly referred to

122. Id. at 381.
123. Kaufman, Exposing Fraud, supra note 6, at 357 (quoting various cases (internal quotations omitted)).
124. In negligence cases, proximate cause has been defined as “the primary moving cause without which [the injury] would not have been inflicted, and which in the natural and probable sequence of events, without the intervention of any new and independent cause, produces the injury.” Winona v. Botzet, 169 F. 321, 328 (8th Cir. 1909). It has also been defined as “[t]hat act or omission which immediately causes or fails to prevent the injury; an act or omission occurring or concurring with another, which, had it not happened, the injury would not have been inflicted.” Black’s Law Dictionary 1225-26 (6th ed. 1990) (quoting Herron v. Smith Bros., 2 P.2d 1012, 1013 (Cal Ct. App. 1931) (internal quotations omitted)).
125. See Steckman & Conner, supra note 16, at 382-84.
126. See, e.g., Athey Prods. Corp. v. Harris Bank Roselle, 89 F. 3d 430, 434 (7th Cir. 1996) (stating that “the elements of common law fraud are: (1) a false statement of material fact; (2) by one who knows or believes it to be false; (3) made with the intent to induce action by another in reliance on the statement; (4) action by the other in reliance on the truthfulness of the statement; and (5) injury to the other resulting from that reliance”).
127. See, e.g., Krauss v. Greenberg, 137 F.2d 569, 572 (3d Cir. 1943) (asserting that for something which is a cause in fact to be a “legal cause” it must have been a substantial factor in bringing about the injury).
128. Additionally, common law fraud principles have guided courts in formulating other elements in Rule 10b-5, such as materiality, scienter, and reliance. See Hazen, supra note 1, at 689.
“transaction causation” or “loss causation,” the Court has addressed certain causation issues through the elements of materiality and reliance. Additionally, the Court has consistently analyzed causation by examining the value of a plaintiff’s investment at the time of the transaction, and the Court has placed little emphasis on post-transaction investment value. Although this analysis is consistent with the minority view of loss causation, which permits loss causation to be established without reference to post-transaction investment value, it does not establish the Court’s support for the minority view because in each case, except for Basic Inc. v. Levinson, post-transaction investment value was irrelevant because it was not being used to measure recoverable loss. As for the Court’s decision in Basic, which comes closest to touching on loss causation-related issues, it too fails to endorse either the minority or majority view for reasons discussed below.

The premise of the plaintiffs’ allegations in Basic was that the defendant’s fraudulent denials of their involvement in merger negotiations artificially depressed market prices and caused the plaintiffs to lose money when they sold their stock shortly after the defendant’s first public misstatement. The plaintiffs used the post-transaction tender offer price of $46 per share as evidence to support their contention that Basic’s stock price at the time of the transaction was artificially depressed.

Although the plaintiffs used the post-transaction price increase in the stock as evidence of their damages, whether the post-transaction price increase was connected to the defendant’s fraud was not at issue. Such a connection was evident because the price increase was directly set by the tender offer, which was the direct result of the merger negotiations that the defendant misrepresented. What was not

129. See Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988) (holding that reliance provides the causal connection between a defendant’s fraud and a plaintiff’s injury); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1972) (ruling that in fraudulent omissions cases, proof of materiality sufficiently establishes causation in fact); see also Kaufman, Exposing Fraud, supra note 6, at 372-79 (discussing Supreme Court jurisprudence on causation).

130. See, e.g., Ute, 406 U.S. at 154-56 (focusing on the effects of the fraud at the time of the transaction and not on the post-transaction performance of the stock); see also Kaufman, Exposing Fraud, supra note 6, at 373-74 (arguing that Supreme Court reasoning in certain cases suggests that plaintiffs need only demonstrate a causal connection between the defendant’s misconduct and the injury suffered at the time of the transaction).

131. For a detailed discussion of the difference between the majority and minority views, see infra Part II.C.


133. See, e.g., Ute, 406 U.S. at 154-55 (measuring damages based on the difference between the value the plaintiffs’ received at the time of the transaction and the fair value of what the plaintiffs should have received had there been no fraud).

134. See Basic, 485 U.S. at 228.

135. See id.
evident, however, was whether the plaintiffs sold their stock in reliance on the defendant's fraudulent misstatements. Thus, the court focused its attention on the element of reliance.

In its discussion of reliance, the Court also touched upon causation issues, stating that reliance provides the "requisite causal connection" between a plaintiff's loss and a defendant's fraud and that there is more than one way for a plaintiff to demonstrate a "causal connection." This language suggests that the Court was adopting a broad view of causation.

With respect to the reliance issue, the Court held that a rebuttable presumption of reliance exists in fraud-on-the-market cases. According to the Court,

[t]he fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business.... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.

The Court concluded that to rebut the presumption of reliance a defendant would have to sever the causal link and prove that the fraud did not distort the stock price or that the plaintiff sold or would have sold the stock despite his knowing of the defendant's fraud.

Some courts interpreted Basic as also creating a presumption of loss causation. These courts assert that in fraud-on-the-market cases, causation is established by the simple fact that a plaintiff relied on the integrity of a price that had been artificially altered by the defendant's fraud at the time of the transaction. Other courts, however, maintain that proof of loss causation is still required. They argue that fraud-on-the-market theory supports only a rebuttable presumption of reliance and not a presumption of causation. These

136. Id. at 243.
137. See id. at 247.
138. Id. at 241-42 (quoting Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).
139. See id. at 248.
140. See, e.g., In re Control Data Corp. Sec. Litig., 933 F.2d 616, 619-20 (8th Cir. 1991) (holding that causation is presumed to the extent that the defendant's fraud altered the stock price and defrauded the market); see also Howard O. Godnick & Bridget Calhoun, Loss Causation: A Defendant's Secret Weapon, N.Y. L.J., Dec. 24, 1997, at 1 (explaining that some courts allow a presumption of loss causation in fraud-on-the-market cases).
141. See Control Data Corp., 933 F.2d at 619-20.
142. See, e.g., Robbins v. Koger Properties, Inc., 116 F.3d 1441, 1448 (11th Cir. 1997) (ruling that the Supreme Court's articulation of the fraud-on-the-market theory supports a rebuttable presumption of reliance, but not a rebuttable presumption of causation); see also Godnick & Calhoun, supra note 140, at 1 (citing Robbins as a recent example of a case in which a court ruled that loss causation is not presumed in fraud-on-the-market cases).
143. See Robbins, 116 F.3d at 1448.
courts reason that Basic did not alter loss causation analysis as developed by the lower courts because reliance is related to transaction causation, not loss causation. Thus, Basic heightened the division between the competing notions of loss causation and made reaching of a unified understanding of loss causation more important.

Although the Supreme Court has arguably adopted a broad view of causation, the Court has never directly addressed loss causation. Instead, the Court has only touched upon causation issues through its discussions of other elements. The Court has thus failed to provide lower courts with a guiding rule for loss causation analysis.

C. Majority v. Minority View of Loss Causation

The majority of circuits view loss causation in narrow terms. These circuits require a plaintiff to specifically identify how the defendant's fraud caused the alleged loss. Under the majority view, a plaintiff who uses post-transaction investment value to measure recoverable loss must establish a connection between the post-transaction investment value and the defendant's fraud. The minority view defines loss causation in broader terms and allows a plaintiff to satisfy the loss causation requirement by establishing a general connection between the alleged loss and the defendant's fraud. Under the minority view, a plaintiff who uses post-transaction investment value to measure recoverable loss does not necessarily have to link the defendant's fraud to the post-transaction investment value. The plaintiff can establish loss causation by simply demonstrating that the defendant's fraud was in some way responsible for artificially altering the transaction price. It is therefore easier for plaintiffs in minority-view jurisdictions to satisfy

144. See id.
145. See supra note 129 and accompanying text.
146. See infra notes 163, 179, 207.
147. See infra notes 163, 179, 207.
148. See infra notes 163, 179, 207; see also Berger & Buckser, supra note 16, at 476-78 (discussing cases in which courts have examined loss causation by determining whether a defendant's fraud touched upon reasons for the investment's price decline); Godnick & Calhoun, supra note 140, at 1 (stating that some courts require plaintiffs to prove that the defendant's fraud caused a post-transaction drop in the price of their investment).
149. See infra note 233.
150. See infra note 233; see also Berger & Buckser, supra note 16, at 478-79 (explaining that in some jurisdictions plaintiffs can establish loss causation by proving that the defendant's fraud artificially altered the investment price at the time of the transaction); Godnick & Calhoun, supra note 140, at 1 (noting that certain courts allow plaintiffs to satisfy the loss causation requirement by showing that the investment price on the purchase date was artificially inflated because of the defendant's fraud).
151. See infra note 233.
the loss causation requirement.

1. Majority View

Under the majority view, there are three distinct approaches to loss causation: (1) the direct causation approach;\(^{152}\) (2) the foreseeability approach;\(^{153}\) and (3) the materialization-of-the-risk approach.\(^{154}\)

The direct causation approach is the most rigid of the three approaches, focusing exclusively on whether a defendant's fraud directly caused the plaintiff's alleged loss.\(^{155}\) Plaintiffs who use post-transaction investment value to measure recoverable loss must prove that the post-transaction investment value was directly linked to the defendant's fraud.\(^{156}\) This approach emphasizes the need for a plaintiff to establish an unbroken "chain of causation."\(^{157}\)

The foreseeability approach, on the other hand, is the most flexible of the three approaches. Under the foreseeability approach, a plaintiff must prove that at the time of the transaction it was reasonably foreseeable that the defendant's fraud would cause the alleged injury.\(^{158}\) Plaintiffs who use post-transaction investment value to measure recoverable loss must demonstrate that the post-transaction loss was a reasonably foreseeable consequence of the defendant's fraud.\(^{159}\)

Finally, the materialization-of-the-risk approach, which is less strict than the direct causation approach, but stricter than the foreseeability approach, requires plaintiffs to prove that the materialization of an undisclosed risk caused the alleged loss.\(^{160}\) A plaintiff who uses post-transaction investment value to measure recoverable loss must show that the defendant exposed him to an undisclosed risk at the time of the transaction and that the post-transaction loss resulted from the materialization of that undisclosed risk.\(^{161}\)

It is important to note that use of one approach does not necessarily preclude the use of another. Direct causation is strong evidence of both foreseeability and materialization of an undisclosed risk. Thus, courts that follow the foreseeability approach or the materialization-of-the-risk approach would probably allow a plaintiff to establish loss

\(^{152}\) See infra note 163; see also Steckman & Conner, supra note 16, at 411-13 (describing the direct causation approach).

\(^{153}\) See infra note 179; see also Steckman & Conner, supra note 16, at 412 (describing the foreseeability approach).

\(^{154}\) See infra note 207; see also Steckman & Conner, supra note 16, at 412 (describing the materialization-of-the-risk approach).

\(^{155}\) See infra note 163.

\(^{156}\) See infra note 163.

\(^{157}\) Steckman & Conner, supra note 16, at 411-12.

\(^{158}\) See infra note 179.

\(^{159}\) See infra note 179.

\(^{160}\) See infra note 207.

\(^{161}\) See infra note 207.
causation by satisfying the direct causation approach.\textsuperscript{162}

\textbf{a. The Direct Causation Approach}

The direct causation approach is the strictest approach to loss causation. Under the direct causation approach, the burden of proof for a plaintiff is the most onerous because he must demonstrate that his economic harm was directly caused by the defendant’s fraud. The Fourth, Fifth, Sixth, and Eleventh Circuits have all utilized the direct causation approach.\textsuperscript{163} These courts have examined the issue of loss causation by focusing on the sequence of events that occurred between the defendant’s fraudulent misconduct and the plaintiff’s alleged injury.\textsuperscript{164}

A recent example of a case that illustrates a court’s use of the direct causation approach is \textit{Robbins v. Koger Properties, Inc.}.\textsuperscript{165} \textit{Robbins} involved a class action suit filed against a corporation, its officers, and its accounting firm.\textsuperscript{166} According to plaintiffs, fraudulent financial statements artificially inflated Koger Properties, Inc.’s (“KPI”) stock price.\textsuperscript{167} Plaintiffs evidenced the price inflation by maintaining that “an adjustment in the stated amount of cash flow in July 1989, the beginning of the class period, would have required KPI to cut or eliminate its dividend, causing a $10.05 decline in KPI’s stock price like the decline that occurred in October 1990.”\textsuperscript{168} The Eleventh Circuit found that this was not enough to satisfy the loss causation requirement and stated that proof of an artificially inflated price, without more, does not satisfy the loss causation requirement.\textsuperscript{169} The

\footnotesize{\textsuperscript{162} See infra notes 202, 228 and accompanying text.  
\textsuperscript{163} See, e.g., Robbins v. Koger Properties, Inc., 116 F.3d 1441, 1447 (11th Cir. 1997) (ruling that loss causation requires a plaintiff to prove that the defendant’s fraud directly or proximately caused the investment’s decline in value); Carlton v. Franklin, 911 F.2d 721, Nos. 89-2942 & 89-2972 to 89-2974, 1990 WL 116788, at *4-5 (4th Cir. Aug. 2, 1990) (per curiam) (unpublished table decision) (holding that loss causation required the plaintiffs to prove that the defendants’ fraud “in some reasonably direct way, ‘touch[ed] upon’ the reason for the investment’s decline in value” and explaining that a strict approach to loss causation prevents the federal securities laws from becoming an insurance program for investors (quoting Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981), aff’d in part and rev’d in part on other grounds, 459 U.S. 375 (1983)); Campbell v. Shearson/American Express Inc., 829 F.2d 38, Nos. 85-1703, 85-1714, 1987 WL 44742, at *2 (6th Cir. Sept. 9, 1987) (unpublished table decision) (finding that the plaintiff’s argument failed to make a distinction between reliance and causation and that the plaintiff never demonstrated that the defendant’s fraud directly caused a decline in the value of the investment).  
\textsuperscript{164} See supra note 163; see also Steckman & Conner, supra note 16, at 411-12 (discussing the direct causation approach).  
\textsuperscript{165} 116 F.3d 1441 (11th Cir. 1997).  
\textsuperscript{166} See id. at 1441-42.  
\textsuperscript{167} See id. at 1446.  
\textsuperscript{168} Id. at 1446-47.  
\textsuperscript{169} See id. at 1448.
court concluded that plaintiffs failed to prove loss causation because they never provided "evidence that [the] price inflation was removed from the market price of KPI stock." 170

According to the court, the plaintiff's actual loss was the decline in the price of their stock, which was caused by the company's cut in their dividend and not the fraudulent financial statements. 171 The court expressly rejected Eighth and Ninth Circuit precedent, stating that those courts had incorrectly merged reliance and loss causation into one analysis and that reliance and loss causation should be treated as distinct elements. 172 The Eleventh Circuit further asserted that proving loss causation requires a plaintiff to demonstrate that the defendant's fraud caused his loss "in some reasonably direct, or proximate, way." 173 Thus, in Robbins, the Eleventh Circuit examined loss causation under the direct causation approach.

Campbell v. Shearson/American Express Inc. 174 demonstrates direct causation analysis in the context of a case involving fraudulent inducement. In Campbell, the plaintiff claimed that the defendant fraudulently induced him to enter into a risky investment in order to earn higher and undisclosed commissions. 175 The defendant contended that the plaintiff was an active investor who understood and accepted the risks associated with his investments. 176 The Sixth Circuit held that the plaintiff's argument failed to make a distinction between reliance and causation, and that the plaintiff never proved that the defendant's fraud caused his loss "in some reasonably direct, or proximate, way." 177 Thus, the plaintiff failed to establish loss causation because he did not satisfy his burden under the direct causation approach.

As these cases illustrate, courts utilizing the direct causation approach require plaintiffs to prove a direct causal connection between their pecuniary injury and the defendant's fraud. Under this approach, plaintiffs carry the heaviest burden of proof.

b. The Foreseeability Approach

A second approach to loss causation is the foreseeability approach, which is the most flexible approach under the majority view. Courts using the foreseeability approach require plaintiffs to prove that their

170. Id.
171. See id. at 1448-49.
172. See id. at 1448.
173. Id. at 1447 (quoting Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375 (1983) (internal quotations omitted)).
175. See id. at *1.
176. See id. at *2-*3.
177. Id. at *2 (citing Huddleston, 640 F.2d at 549).
economic harm was a foreseeable consequence of the defendant's fraud.\footnote{178}{See infra note 179; see also Steckman & Conner, supra note 16, at 412 (discussing the foreseeability approach).} The foreseeability approach has been utilized primarily by the Second Circuit.\footnote{179}{See, e.g., Marbury Management, Inc. v. Kohn, 629 F.2d 705, 708 (2d Cir. 1980) (holding that loss causation "requires that the damage complained of be one of the foreseeable consequences of the misrepresentation").}

*In re Blech Securities Litigation*\footnote{180}{961 F. Supp. 569 (S.D.N.Y. 1997).} is an excellent example of a case in which a court exclusively applied the foreseeability approach. In *Blech*, plaintiffs brought a class action suit against the defendant broker for allegedly using deceptive practices to manipulate the market.\footnote{181}{Id. at 576.} The court advocated the foreseeability approach in finding that the collapse in the price of the securities, which had been inflated by the defendant's fraud, "was a foreseeable consequence" of the defendant's fraud.\footnote{182}{Id. at 708-09.}

The underlying difference between the foreseeability approach and the direct causation approach is best illustrated in *Marbury Management, Inc. v. Kohn*.\footnote{183}{629 F.2d 705 (2d Cir. 1980).} In *Marbury*, the defendant misrepresented himself as a licensed stock broker and sold securities to Marbury Management.\footnote{184}{See id. at 707.} The court found that the defendant's misrepresentation induced the plaintiffs not only to purchase the securities, but also to retain them as the price declined.\footnote{185}{See id. at 708.} The court noted that the length of time that the plaintiffs retained the securities affected the extent of the plaintiffs' loss.\footnote{186}{Id. at 710 n.3.} Although the defendant's fraud was not responsible for the actual decline in the stock price, the court held that loss causation was established because the plaintiffs' injury was a reasonably foreseeable consequence of the defendant's fraud.\footnote{187}{See id. at 708-09.} Thus, the court applied the foreseeability approach.

Although the majority agreed with the dissent that the defendant, who misrepresented himself as a licensed broker, should only be liable for the losses that his fraud "proximately caused,"\footnote{188}{Id. at 710.} the majority differed on its view of proximate cause and stated that:

>[d]ifferentiating transaction causation from loss causation can be a helpful analytical procedure only so long as it does not become a new rule effectively limiting recovery for fraudulently induced securities transactions to instances of fraudulent representations about the value characteristics of the securities dealt in. So concise a theory of liability for fraud would be too accommodative of many
common types of fraud, such as the misrepresentation of a collateral fact that induces a transaction.\footnote{Id.}

Essentially, the majority acknowledged that its loss causation analysis blurred the distinction between loss causation and transaction causation. However, the court saw this as an advantage and pointed out that in some cases a sharp distinction would produce unjust results.\footnote{See id. at 716-18.} Thus, the majority favored the flexibility of the foreseeability approach over the rigidity of direct causation.

In contrast, Judge Meskill’s dissenting opinion argued in support of the direct causation approach.\footnote{See id. at 718 (quoting William L. Prosser, Law of Torts § 110, at 732 (Hornbook Series, 4th ed. 1971))).} Judge Meskill explained that a basic principle of causation is that the plaintiff’s injury must proceed directly from the defendant’s fraud and that fraud is not actionable in cases where the subsequent loss occurs because of an intervening cause.\footnote{Id. at 718.} Judge Meskill additionally posited that:

if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline of the market, or insolvency of the corporation, brought about by business conditions or other factors in no way related to the representations, will not afford any basis for recovery. It is only where the fact misstated was of a nature calculated to bring about such a result that damages for it can be recovered.\footnote{See infra notes 196-201 and accompanying text.}

Judge Meskill supported this contention with the public policy rationale that defendants should not become the insurers of plaintiffs’ investments.\footnote{968 F.2d 1489 (2d Cir. 1992).}

\textit{Marbury} is an important case because it illustrates on one set of facts how the foreseeability approach and the direct causation approach can produce different results. The majority in \textit{Marbury} utilized the foreseeability approach and reached a more plaintiff-friendly conclusion than did Judge Meskill. On a different set of facts, however, the foreseeability approach and the direct causation approach can produce the same result.\footnote{See id. at 1495-97.}

For example, in \textit{Citibank, N.A. v. K-H Corp.},\footnote{See id. at 1495-97.} the Second Circuit concluded that the plaintiff failed to establish causation in its Rule 10b-5 and New York common law fraud claims because it did not prove that its injury was either a foreseeable consequence of the defendants’ fraud or a direct result of the defendants’ fraud.
Citibank, plaintiff Citibank alleged that the defendants fraudulently induced the bank to provide financing for a particular business transaction by failing to disclose to Citibank that a note had been substituted for a portion of a contribution that Citibank had required to be in all cash.198 Addressing Citibank's Rule 10b-5 claim, the court found that Citibank did not prove loss causation because it failed to indicate the cause of the investment's collapse.199 The Second Circuit ruled that loss causation requires a plaintiff to prove that his injury was a "foreseeable consequence" of the defendant's fraud.200 With respect to the common law fraud claim, the court held that Citibank did not establish proximate causation because it failed to specify how the alleged fraud "directly and proximately" caused the injury.201 Thus, this case illustrates how tests of foreseeability and direct causation can sometimes lead a court to the same conclusion.

Under the majority view, the foreseeability approach is the most plaintiff-friendly approach. Because direct causation is strong evidence of foreseeability, courts applying the foreseeability approach allow plaintiffs to establish loss causation by either demonstrating direct causation or foreseeability.202 Direct causation, however, is not required under the foreseeability approach.203 Courts utilizing the foreseeability approach require only that plaintiffs prove that their loss was a foreseeable consequence of the defendant's fraudulent misconduct.204

c. The Materialization-of-the-Risk Approach

The last majority-view approach is the materialization-of-the-risk approach,205 which is stricter than the foreseeability approach, but not as strict as the direct causation approach. A court applying the materialization-of-the-risk approach requires a plaintiff to prove that his loss was caused by the materialization of a risk that was undisclosed because of the defendant's fraud.206 The Seventh Circuit is the principal proponent of the materialization-of-the-risk approach.

198. See id. at 1491-93.
199. See id. at 1495.
200. Id.
201. Id. at 1497.
202. See, e.g., Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp., 801 F.2d 13, 20-21 (2d Cir. 1986) (stating that the district court correctly instructed the jury that the plaintiff established loss causation if it demonstrated that its "damage was either a direct result of the misleading statement or one which could reasonably have been foreseen" (quoting the district court judge) (internal quotations omitted)).
203. See supra notes 183-94 and accompanying text.
204. See supra note 179.
205. See infra note 207.
206. See infra note 207; see also Steckman & Conner, supra note 16, at 412 (discussing the materialization-of-the-risk approach).
approach.\textsuperscript{207}

The materialization-of-the-risk approach was first utilized in \textit{Bastian v. Petren Resources Corp.}\textsuperscript{208} In \textit{Bastian}, the plaintiffs alleged that they suffered financial loss because the defendants' misrepresentations caused them to invest in the defendants' limited partnerships.\textsuperscript{209} The plaintiffs did not, however, indicate why the investment had been wiped out.\textsuperscript{210} Judge Posner stated that the plaintiffs' loss was not due to the defendants' fraud, but to an industry-wide collapse in oil and gas ventures.\textsuperscript{211} The court held that the plaintiffs did not meet their burden of proving loss causation because they had knowingly assumed the risk that oil prices might fall, and never demonstrated that their injury was caused by something other than the materialization of that risk.\textsuperscript{212}

\textit{Mallozzi v. Zoll Medical Corp.}\textsuperscript{213} is a more recent example of a case in which a court relied solely on the materialization-of-the-risk approach. In \textit{Mallozzi}, the plaintiffs, who were all purchasers of defendant corporation's stock, argued that the "risks of which they were unaware when they purchased the stock[, such as] the FDA compliance problems, the significance of Physio-Control's return, and the financial condition of the company—were the risks which, in fact, materialized and triggered the plummeting stock prices."\textsuperscript{214} The court agreed and applied the "materialized risk" test to conclude that the defendants misrepresented the FDA compliance problems and company financial problems, that these risks materialized, and that these problems eventually caused the plaintiff's stock price to drop.\textsuperscript{215} The court also held that the "direct causation" approach in \textit{Huddleston v. Herman & MacLean}\textsuperscript{216} overstated the test for loss causation.\textsuperscript{217}

Although the court in \textit{Huddleston} analyzed loss causation under the direct causation approach, it incorporated the language of materialization of the risk into its direct causation analysis.\textsuperscript{218} In \textit{Huddleston}, the plaintiffs had invested in the Texas International

\textsuperscript{207} See, e.g., Bastian v. Petren Resources Corp., 892 F.2d 680, 684-86 (7th Cir. 1990) (ruling that the plaintiffs failed to demonstrate that the investment declined in value because of the materialization of a risk that was undisclosed because of the defendant's fraud).
\textsuperscript{208} 892 F.2d 680 (7th Cir. 1990).
\textsuperscript{209} See id. at 684.
\textsuperscript{210} See id.
\textsuperscript{211} See id. at 685.
\textsuperscript{212} See id. at 684-86.
\textsuperscript{213} No. 94-11579-NG, 1996 WL 392146 (D. Mass. March 5, 1996).
\textsuperscript{214} Id. at *10.
\textsuperscript{215} See id. at *11.
\textsuperscript{216} 640 F.2d 534 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375 (1983).
\textsuperscript{217} Mallozzi, 1996 WL 392146, at *10.
\textsuperscript{218} See Huddleston, 640 F.2d at 549-50.
Speedway ("TIS"), which filed for bankruptcy shortly after it went public.\textsuperscript{219} As a result, the plaintiffs filed suit, claiming that the defendants' misleading prospectus regarding the cost of constructing the speedway caused their economic loss.\textsuperscript{220} The Fifth Circuit cited Judge Meskill's dissenting opinion in \textit{Marbury}\textsuperscript{221} and held that loss causation refers to the direct causal link between the defendant's fraud and the plaintiff's loss.\textsuperscript{222} The court concluded that the jury should have been allowed to consider the defendants' claim that the plaintiffs' losses were actually caused by the "materialization of risks" listed in the prospectus.\textsuperscript{223} Thus, this case illustrates how the language of materialization of the risk can sometimes be consistent with the language of direct causation.

\textit{Broderick v. Menconi},\textsuperscript{224} on the other hand, demonstrates how the materialization-of-the-risk approach and the direct causation approach can produce different results. In \textit{Broderick}, the defendants fraudulently misrepresented the nature of the plaintiffs' investment as low-risk.\textsuperscript{225} Citing \textit{Bastian}, the court ruled that "[w]here investors are falsely told that an investment is not risky and the risk instead develops, loss causation is satisfied."\textsuperscript{226} Such language is indicative of the materialization-of-the-risk approach, which differs from the direct causation approach in that it takes into consideration the undisclosed risks that a plaintiff is exposed to at the time of the transaction. If the court in \textit{Broderick} had adopted strict direct causation analysis, it would have focused exclusively on whether the plaintiff proved that the defendant's fraud caused the post-transaction decline in the value of the investment. Such analysis probably would have led the court to conclude that loss causation had not been established for reasons similar to those given in \textit{Marbury}'s dissent.\textsuperscript{227} Thus, the direct causation approach is not always consistent with the materialization-of-the-risk approach.

Because the direct causation approach is stricter than the materialization approach, a plaintiff can satisfy the materialization approach by proving direct causation.\textsuperscript{228} Under the materialization-of-the-risk approach, however, the burden of proof for a plaintiff is not

\begin{footnotesize}
\begin{enumerate}
\item See id. at 539.
\item See id.
\item See supra notes 191-94 and accompanying text.
\item See \textit{Huddleston}, 640 F.2d at 549.
\item Id. at 549-50.
\item No. 88-C0161, 1990 WL 51180 (N.D. Ill. Apr. 12, 1990).
\item See id. at *1.
\item Id. at *2.
\item See \textit{Marbury Management, Inc. v. Kohn}, 629 F.2d 705, 716-23 (2d Cir. 1980) (Meskill, J., dissenting); \textit{infra} notes 191-94 and accompanying text.
\item See, e.g., Reshal Assoc., Inc. v. Long Grove Trading Co., 754 F. Supp. 1226, 1234 (N.D. Ill. 1990) (referring to the \textit{Bastian} materialization-of-the-risk test and concluding that the plaintiffs established loss causation because they specifically alleged that their losses were "a direct result" of the defendants' fraud).
\end{enumerate}
\end{footnotesize}
as high as under the direct causation approach and thus a plaintiff is not required to prove direct causation. Rather, the focus of a court's inquiry is on whether the plaintiff's injury was caused by the materialization of a risk that was undisclosed to the plaintiff because of the defendant's fraud.

Although the degree of flexibility varies with each majority-view approach, all three approaches share one common feature. Under each approach, a plaintiff who uses post-transaction investment value to measure recoverable loss must establish a connection between the post-transaction investment value and the defendant's fraud. This common characteristic is the fundamental difference between the majority and minority views of loss causation.

2. The Minority View

The minority view, also known as the "some causal nexus" approach, allows a plaintiff to establish loss causation by simply demonstrating that the defendant's fraud was connected to a loss sustained at the time of the transaction. The "some causal nexus approach" expressly rejects the majority view and allows plaintiffs to establish causation by broadly demonstrating a connection between their loss and the defendant's misconduct. The Eighth and Ninth Circuits both advocate this approach.

In In re Control Data Corp. Securities Litigation, the Eighth Circuit stated that "[p]laintiffs are not required to meet a strict test of direct causation under Rule 10b-5; they need only show 'some causal nexus.'" The plaintiff stock purchasers in the case claimed that defendant Control Data Corporation ("CDC") misrepresented their current and future earnings in a number of public statements. Defendant argued that the plaintiffs did not establish causation because the stock price did not significantly change after it corrected

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229. See supra notes 163, 179, 207; see also supra notes 146-51 and accompanying text (explaining how the majority view differs from the minority view).
231. See infra note 233; see also supra notes 146-51 and accompanying text (explaining how the minority view differs from the majority view).
232. See infra note 233; see also Steckman & Conner, supra note 16, at 413 (discussing the "some causal nexus" approach).
233. See, e.g., Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996) (ruling that the plaintiffs did not have to prove that the defendant's fraud caused a decline in the stock price and that the plaintiffs, who both purchased and sold their stock before the release of the corrective statements, could recover because they proved that the stock price was artificially inflated at the time of the transaction); In re Control Data, 933 F.2d at 619-20 (holding that the plaintiff did not have to establish direct causation and that causation is presumed to the extent that the defendant's violations defrauded the market and artificially altered the stock price at the time of the transaction).
234. 933 F.2d 616 (8th Cir. 1991).
235. Id. at 619.
236. See id. at 617.
its fraudulent error.237 The defendant also pointed out that the drop in value occurred only after it revealed the status of its loan covenants,238 which it did not have a duty to disclose.239 The court viewed this conception of causation as too narrow and ruled that "[a] jury could reasonably find that CDC's improper accounting artificially altered the price of CDC stock in a variety of ways."240 Thus, the minority view allows a plaintiff to attribute its loss to an artificially altered transaction price, and it does not require a plaintiff to prove that the defendant's fraud caused a post-transaction decline in the value of the investment.

Arthur Young & Co. v. Reves241 is another example of the Eighth Circuit's adoption of the minority view. In Arthur Young, plaintiffs were the purchasers of demand notes sold by the Farmer's Cooperative of Arkansas and Oklahoma, Inc.242 The defendant argued that the plaintiffs did not demonstrate loss causation because the plaintiffs were injured by the Co-op's bankruptcy, which was unrelated to the defendant's alleged fraud.243 Applying its broad test for loss causation, the Eighth Circuit concluded that the plaintiffs' evidence was sufficient because it indicated that the Co-op would have had considerable financial problems had the defendant made the appropriate disclosure.244 The court also stated that a reasonable jury could have found that the defendant's fraudulent misconduct contributed to the Co-op's bankruptcy.245 Thus, the holdings in both In re Control Data Corp. Securities Litigation and Arthur Young make it clear that the Eighth Circuit's approach to loss causation is the most plaintiff-friendly of all approaches.

The Ninth Circuit seems to have shifted its position on loss causation from the narrow direct causation approach to the broad "some causal nexus" approach. In McGonigle v. Combs,246 plaintiffs alleged that defendant's misrepresentations and omissions affected the "quality" of their investment in a private placement of stock in a California horse breeding company.247 The plaintiffs contended that their loss was caused by the defendant's fraud because the fraud induced them to purchase stock, which subsequently declined in value.248 The court disagreed and stated that such a contention

237. See id. at 618.
238. See id. at 619.
239. See id.
240. Id. at 619-20.
242. See Arthur Young, 937 F.2d at 1315.
243. See id. at 1332.
244. See id.
245. See id.
246. 968 F.2d 810 (9th Cir. 1992).
247. See id. at 820.
248. See id. at 821.
“renders the concept of loss causation meaningless by collapsing it into transaction causation.” To support its position, the Ninth Circuit quoted a passage in Huddleston that stated, “the [defendant’s] untruth [must] in some reasonably direct, or proximate, way [be] responsible for [the plaintiff’s] loss.”

Although McGonigle squarely supports the direct causation approach, Ninth Circuit cases subsequent to McGonigle have retreated from its narrow conception of loss causation. In Knapp v. Ernst & Whinney, the Ninth Circuit ruled that in fraud-on-the-market cases, a plaintiff can satisfy the loss causation requirement by proving that the defendant’s fraud artificially altered the purchase price of the investment. Knapp involved a class action brought by investors in ATV stock against the defendant accounting firm for alleged misrepresentations in financial statements. Defendant argued that loss causation required the plaintiffs to prove that the defendant’s fraud caused the stock price to drop and that the plaintiffs, who both purchased and sold their stock before public disclosure of the defendant’s fraud, failed the loss causation requirement as a matter of law. The court disagreed, opining that market forces created by the defendant’s fraud could cause price fluctuations to occur prior to public disclosure of the fraud. The court further remarked that while the post-disclosure price of a stock can be used as evidence of the pre-disclosure value of that stock, post-disclosure price does not directly measure pre-disclosure value.

Additionally, in Provenz v. Miller, the Ninth Circuit was extremely plaintiff-friendly in holding that the burden of proof is extremely heavy for a defendant who wishes to prove that the cause responsible for the plaintiff’s injury was not the one that the plaintiff alleges. In Provenz, the plaintiffs claimed that the value of the stock they had purchased was artificially inflated because of the defendants’ fraud. Plaintiffs also alleged that the stock price fell soon after the fraud was disclosed. The court ruled that for the defendants to establish loss causation as a defense, they would have to prove, as a matter of law, that factors other than the alleged misconduct caused the stock price to fall. The court also ruled that the plaintiffs had

249. Id.
250. Id.
251. 90 F.3d 1431 (9th Cir. 1996).
252. See id. at 1438.
253. See id. at 1434-35.
254. See id. at 1438.
255. See id.
256. See id.
257. 102 F.3d 1478 (9th Cir. 1996).
258. See id. at 1492.
259. See id. at 1482.
260. See id. at 1492.
261. See id.
successfully established loss causation because they demonstrated that the defendant's fraud "'touched upon'" both the "overvalued price of the stock" and "the fall in the price of the ... stock."\textsuperscript{262} Although it is unclear whether loss causation would have been established if the plaintiffs had only proved that the stock price was overvalued at the time of the transaction, both the holding in \textit{Knapp} and the shifting of the burden of proof in \textit{Provenz} indicate that the Ninth Circuit, like the Eighth Circuit, views loss causation in very broad terms.

The minority view of loss causation is more plaintiff-friendly than any majority-view approach because minority-view plaintiffs can establish loss causation by simply demonstrating that the defendant's fraud was in some way responsible for artificially altering the transaction price.\textsuperscript{263} In contrast, majority-view plaintiffs who measure recoverable loss based on post-transaction investment value must establish a connection between the defendant's fraud and the post-transaction loss.\textsuperscript{264} This fundamental difference between the two views greatly affects the extent of a plaintiff's burden of proof and can ultimately be the principal factor in determining whether a plaintiff's claim will succeed or fail. Thus, a substantial degree of inconsistency and uncertainty currently exists in federal securities law jurisprudence, which is likely to continue unless the conflict among courts is resolved. The next part provides a detailed examination of the passage of the PSLRA and its relevant provisions, which will play a critical role in formulating a unified approach to loss causation.

\section*{III. The Private Securities Litigation Reform Act of 1995}

In 1995, Congress enacted the PSLRA in order to reduce abusive practices in federal securities litigation. Among other things, the PSLRA codified loss causation by adding section 21D(b)(4) to the 1934 Act. Section 21D(b)(4) expressly states that "[i]n any private action arising under this chapter, 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...

\textsuperscript{262} Id.

\textsuperscript{263} See supra note 233; see also Berger & Buckser, \textit{supra} note 16, at 478-79 (stating that some courts allow plaintiffs to establish loss causation by showing that the defendant's fraud artificially altered the investment price at the time of the transaction); Godnick & Calhoun, \textit{supra} note 140, at 1 (explaining that in certain jurisdictions plaintiffs can satisfy the loss causation requirement by demonstrating that the investment price on the purchase date was artificially inflated because of the defendant's fraud).

\textsuperscript{264} See supra notes 163, 179, 207; see also Berger & Buckser, \textit{supra} note 16, at 476-78 (examining cases in which courts have analyzed loss causation by determining whether a defendant's fraud touched upon reasons for the investment's price decline); Godnick & Calhoun, \textit{supra} note 140, at 1 (noting that some courts require plaintiffs to prove that the defendant's fraud caused a post-transaction drop in the price of their investment).
damages."265

Unfortunately, the statute does not provide a clear analytical approach to guide courts in determining whether a plaintiff has sufficiently pled loss causation. Although the codification of loss causation does not resolve the split among the courts, it does provide courts with a central authority for loss causation analysis. The PSLRA establishes a firm foundation for evaluating the various loss causation approaches, and thus analysis of the PSLRA is essential to developing a resolution to the loss causation controversy. This part describes the PSLRA’s history and the Congressional rationale for creating the law.

A. Legislative History

In 1991, the “Big Six” accounting firms and the American Institute of Certified Public Accountants launched a lobbying campaign to gain bipartisan support for legislation that would reform private securities litigation.266 In their opinion, the laws governing private securities litigation disproportionately favored plaintiffs and encouraged the filing of frivolous lawsuits.267 Corporations contended that they were victims of meritless class actions that were filed for the sole purpose of extorting settlements.268

The final push for securities litigation reform came during the 1994 elections.269 The Republicans made securities reform a part of their “Contract With America” platform and, after successfully capturing the majority of seats in both the Senate and the House of Representatives, securities reform seemed inevitable.270 Immediately upon the opening of the 104th Congress, Representative Henry J. Hyde (R-Ill.) and 118 co-sponsors introduced H.R. 10, entitled the “Common Sense Legal Reform Act of 1995” (the “House Reform Act”).271 Title II of the House Reform Act addressed securities litigation reform and contained provisions that “could have eliminated virtually all class actions under the federal securities laws.”272 The House Reform Act also contained a loss causation provision that stated the following:

267. See id.
269. See Phillips & Miller, supra note 266, at 1018-19 & n.63.
270. See id.
272. Phillips & Miller, supra note 266, at 1019.
concerning a security, the plaintiff must prove that he or she had actual knowledge of and actually relied on such statement in connection with the purchase or sale of a security and that the misstatement or omission proximately caused (through both transaction causation and loss causation) any loss incurred by the plaintiff.\textsuperscript{273}

In February 1995, House Commerce Committee Chairman Thomas J. Bliley (R-Va.) introduced a revised bill ("H.R. 1058"),\textsuperscript{274} which was passed in the House the following month.\textsuperscript{275} H.R. 1058 was essentially the reported version of Title II of the House Reform Act with some minor changes.\textsuperscript{276} The first three versions of H.R. 1058 addressed loss causation in the following manner: "(1) In general.—in any private action to which subsection (a) applies, the plaintiff shall prove that . . . (B) [ ] the statement containing such misstatement or omission proximately caused (through both transaction causation and loss causation) any loss incurred by the plaintiff."\textsuperscript{277}

In January 1995, Senators Christopher J. Dodd (D-Conn.) and Pete V. Domenici (R-N.M.) introduced reform bill S. 240 in the Senate as "The Private Securities Litigation Reform Act of 1995."\textsuperscript{278} This bill was more moderate than the House bill,\textsuperscript{279} but addressed similar issues and shared the goal of diminishing abusive practices in securities litigation.\textsuperscript{280} The first version of the bill, dated January 22, 1995, contained the following loss causation provision:

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\textsuperscript{273} H.R. 10 § 204. Loss causation was first introduced into the mix of reform issues on May 17, 1994, when the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs released a staff report on private securities litigation. See Avery, supra note 271, at 362 n.189. In the staff report the subcommittee expressed concern about courts adopting "a presumption of loss causation (as well as reliance) in fraud-on-the-market cases." Id. The subcommittee specifically stated:

Even if the fraud-on-the-market theory is a reasonable means of establishing reliance, it is unclear that the theory should also be used to impute causation. There may be cases in which the plaintiff reasonably relied on the integrity of the market price, but the market price was not affected by the defendant’s misrepresentation because other information in the market neutralized any impact which the misrepresentation might have had. It may therefore be appropriate to require plaintiffs to provide proof in fraud-on-the-market cases that the alleged misrepresentation caused an effect on market price.

Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, Staff Report on Private Securities Litigation 228 (May 17, 1994) (prepared at the direction of Sen. Dodd).

\textsuperscript{274} See H.R. 1058, 104th Cong. (1995) (enacted); see also Phillips & Miller, supra note 266, at 1019 & n.70 (discussing the introduction of H.R. 1058).

\textsuperscript{275} See Phillips & Miller, supra note 266, at 1019.

\textsuperscript{276} See id.

\textsuperscript{277} H.R. 1058 § 4.

\textsuperscript{278} See S. 240, 104th Cong. (1995); see also Avery, supra note 271, at 350 (discussing the introduction of S. 240).

\textsuperscript{279} See supra notes 274-77 and accompanying text.

\textsuperscript{280} See Phillips & Miller, supra note 266, at 1020.
and in which the plaintiff claims to have bought or sold the security based on a reasonable belief that the market value of the security reflected all publicly available information, the plaintiff shall have the burden of proving that the misstatement or omission caused any loss incurred by the plaintiff.\(^{281}\)

The bill was later modified by a loss causation provision amending section 12\(^{282}\) of the 1933 Act, which gave defendants the opportunity to demonstrate that the plaintiff's loss was the result of intervening factors.\(^{283}\) Although this provision does not apply to Rule 10b-5 actions, it does contain the term "loss causation" and thus provides more insight into what the PSLRA meant by the term "loss causation."\(^{284}\)

After months of negotiation, conferees of both houses met in November 1995, reconciled the differences in the House and Senate bills, and filed a Conference Report on the revised House bill.\(^{285}\) Although the conferees made several significant changes, the bill's final form was predominantly based on the Senate's version. In addition to the House Conference Report,\(^{286}\) the conferees also filed a "Statement of Managers" that contained a description of the purpose and intent of the bill.\(^{287}\) On December 5, 1995, the Senate passed the House Conference Report\(^{288}\) and the following day the House also passed the bill.\(^{289}\) However, less than an hour before it would have become law, President Clinton unexpectedly vetoed the bill.\(^{290}\)

Congress responded quickly. On December 20, 1995, the veto was overridden by the House of Representatives\(^{291}\) and on December 22, 1995, it was overridden by the Senate.\(^{292}\) Thus, on December 22, 1995, the PSLRA was voted into law.\(^{293}\)

**B. Purpose of the PSLRA and Section 21D(b)(4)**

Congress submitted two reports with the PSLRA legislation that gave a detailed description of the purpose for the PSLRA's enactment. The first report was Senate Report No. 104-98 (the

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281. S. 240 § 104.
283. See 15 U.S.C. § 77l(b) (Supp. 1997); infra note 333 and accompanying text.
284. See infra notes 332-35 and accompanying text.
286. See id.
287. See id.
"Senate Report"), which was created by the Banking, Housing, and Urban Affairs Committee on June 19, 1995. The second report was House Conference Report No. 104-369 (the "House Report"), which was created by conferees of both chambers on November 28, 1995. In addition to stating Congress's reasons for enacting the PSLRA, both reports also expressed Congress's underlying rationale for codifying loss causation by adding section 21D(b)(4) to the 1934 Act via the PSLRA.

1. The Senate Report

According to the Senate Report, the Banking Committee heard substantial testimony that the cost of raising capital for businesses was being significantly increased by the rising number of frivolous securities suits that "professional plaintiffs" were filing against corporate defendants pursuant to federal securities laws. The report noted that lawyers brought frivolous suits because defendants often settled in order to avoid the exorbitant costs associated with litigation. Taking these findings into consideration, the report asserted that the PSLRA was intended to combat abuses in federal securities litigation without reducing the incentives for filing meritorious claims.

The report also made clear that Congress wanted to reassert its authority in the area of securities fraud in order to reconcile the "conflicting legal standards" that had developed as a result of section 10(b) litigation evolving out of case law. According to the report, these "conflicting legal standards" created too many uncertainties and opportunities for abusive practices.

With respect to loss causation, the report stated that the loss causation provision in S. 240 was another provision designed to reduce the cost of raising capital. In other words, it was intended to make it more difficult for a plaintiff to establish a cause of action. Under the heading "A strong pleading requirement," the report further discussed loss causation and specifically stated that:

The Committee also requires the plaintiff to show that the
misstatement or loss alleged in the complaint caused the loss incurred by the plaintiff. For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission. The defendant would then have the opportunity to prove any mitigating circumstances, or that factors unrelated to the fraud contributed to the loss.\(^\text{305}\)

Both the heading “A strong pleading requirement” and the language used in this description of the loss causation provision indicate that Congress codified loss causation by adding section 21D(b)(4) to the 1934 Act via the PSLRA in order to increase the plaintiff’s burden of proof.

2. The House Report

The House Report included a Statement of Managers, which set forth the purpose of the PSLRA and provided a brief description of the PSLRA’s various provisions.\(^\text{306}\) According to the House Report, both the House and Senate Committees heard evidence of the following abusive practices: (1) lawyers filing frivolous lawsuits against deep-pocket defendants without having any evidence of fraud; (2) plaintiffs using the discovery process to impose excessive costs on defendants in order to induce settlement; and (3) class action lawyers manipulating their clients.\(^\text{307}\) The Act was intended to remedy these abuses.

Under the heading “Loss causation,” the House Report gave the following description:

The Conference Committee also requires the plaintiff to plead and then to prove that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff in new Section 21D(b)(4) of the 1934 Act. For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.\(^\text{309}\)

Like the Senate Report, the language used in this description of loss causation suggests that the purpose of the loss causation provision was to increase the pleading and proof requirements for a plaintiff.

The legislative history of the PSLRA, the Senate Report, and the House Report all support the contention that loss causation was codified in section 21D(b)(4) of the 1934 Act via the PSLRA in order

\(^{305}\) Id. at 15, reprinted in 1995 U.S.C.C.A.N. 694.


\(^{308}\) See id.

\(^{309}\) Id. at 41, reprinted in 1995 U.S.C.C.A.N. 740.
to make it more difficult for plaintiffs to file frivolous securities suits. The bills leading up to the PSLRA all provided that loss causation is the plaintiff's burden. Likewise, the Senate Report and House Report both state that the plaintiff must prove that the defendant's fraud actually caused the loss incurred by the plaintiff. Although various reports suggest that the PSLRA was not successful at accomplishing all of its goals, the fact remains that Congress added section 21D(b)(4) to the 1934 Act via the PSLRA in order to heighten a plaintiff's burden of proof in lawsuits brought pursuant to the federal securities laws. The next part utilizes this fact as a basis for constructing a resolution to the loss causation controversy.

IV. Resolution

This part uses the PSLRA as a foundation to critique the various loss causation approaches. It proposes that in light of the PSLRA's goals, the materialization-of-the-risk approach is the optimal approach to loss causation.

Although courts continue to rely on the precedents set prior to its enactment, the PSLRA is a central authority on loss causation that

310. See supra notes 266-68, 298-309 and accompanying text.
311. See supra notes 271-81 and accompanying text.
312. See supra notes 298-309 and accompanying text.
313. At first the PSLRA appeared to be successful, but eventually a number of studies led Congress to conclude that additional legislation would be necessary to curtail securities fraud litigation. See Securities Litigation Uniform Standards Act of 1998, 105 Pub. L. No. 105-353, § 2, 112 Stat. 3227, 3227 (1998) (codified as amended in scattered sections of 15 U.S.C.). National Economic Research Associates ("NERA") conducted the first study to examine the impact of the PSLRA on securities fraud litigation. See Frank Placenti, Litigation Reform Incomplete: Class-Action Lawsuits Continue to Hamper Market, Ariz. Republic, Apr. 24, 1997, at E2. The NERA study revealed that in early 1996, immediately after Congress passed the PSLRA, the number of securities lawsuits filed in federal courts declined; however, increased filings in the latter half of the year resulted in little change between the 1995 and 1996 federal class action filings. See id. The NERA study also indicated that the number of state filings had increased since the passage of the PSLRA. See id. The second study to examine the effects of the PSLRA on securities fraud litigation was conducted by two Stanford University law professors. See id. According to the Stanford study, the number of federal class action cases filed had declined between 1995 and 1996; however, the number of state filings increased and the total number of class action securities fraud filings remained unchanged. See id. Finally, in early 1998, the SEC reported that the number of federal class action securities fraud filings rose to 175 in 1997 from 106 in 1996. See Class-Action Lawsuits Stage '97 Rebound Despite Legal Curbs, Wall St. J., Feb. 19, 1998, at B2. In response to these studies and to prevent the objectives of the PSLRA from being frustrated by state private securities class action lawsuits, Congress passed the Securities Litigation Uniform Standards Act of 1998, which purported to solve the problem by limiting the conduct of securities class actions under state law. See Securities Litigation Uniform Standards Act of 1998, 105 Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended in scattered sections of 15 U.S.C.). President Clinton signed the Act into law on Nov. 3, 1998. See id.
314. See, e.g., Coates v. Heartland Wireless Communications, Inc., 26 F. Supp. 2d 910, 923 (N.D. Tex. 1998) (holding that "the PSLRA does not alter the standards for
can guide courts in their loss causation analyses. On its surface the
PSLRA codifies loss causation by adding section 21D(b)(4) to the
1934 Act. Section 21D(b)(4) expressly states that “[i]n any private
action arising under this chapter, 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.”315 While this description of loss causation does not
expressly indicate the approach that courts should utilize, it does
provide courts with a central rule from which a single understanding
of loss causation can be formed. Developing such an understanding
simply requires courts to draw upon the legislative history of the
PSLRA so that Congress’s meaning of loss causation can be fully
appreciated.

The legislative history of the PSLRA predominantly favors the
majority view of loss causation for two primary reasons. First,
Congress enacted the PSLRA in order to make it more difficult for
plaintiffs to file frivolous securities suits.316 Likewise, the majority
view heightens a plaintiff’s burden by requiring plaintiffs who use
post-transaction investment value to measure recoverable loss to
prove that the defendant’s fraud caused the post-transaction loss.317
Second, loss causation was first introduced into the mix of reform
issues because the Subcommittee on Securities of the Senate
Committee on Banking, Housing, and Urban Affairs was concerned
about loss causation being presumed in fraud-on-the-market cases.318
Courts following the majority view have also ruled that loss causation
cannot be presumed in fraud-on-the-market cases, whereas courts
following the minority view have concluded that loss causation can be
presumed in such cases.319

Some of the language used in the Senate Report320 also supports the
majority view. According to the Senate Report, a plaintiff is required
to prove that the defendant’s fraud caused a “loss in the value of their
stock.”321 The minority view never requires a plaintiff to prove that

pleading loss causation”); Retsky Family Ltd. Partnership v. Price Waterhouse, LLP,
PSLRA to its scienter analysis, but failing to apply it to its loss causation analysis).
But see, e.g., Castillo v. Dean Witter Discover & Co., No. 97 Civ. 1272 (RPP), 1998
WL 342050, at *4 (S.D.N.Y. June 25, 1998) (recognizing that the purpose of the
PSLRA was to make a more stringent pleading standard for each Rule 10b-5 element
and holding that the “PSLRA requires plaintiffs to link each act or omission of the
defendant to the plaintiffs’ alleged losses” (citation omitted)).
316. See supra Part III.
317. See supra Part II.C.
318. See supra note 273.
319. See supra notes 140-44 and accompanying text.
320. See supra note 294; Part III.B.1.
the defendant's fraud caused such a loss.  Rather, the minority view requires only that the plaintiff demonstrate that the defendant's fraud was in some way responsible for artificially altering the transaction price.  The majority view, on the other hand, requires plaintiffs, who use post-transaction investment value to measure recoverable loss, to demonstrate that the defendant's fraud caused the post-transaction change in the value of the investment.  Thus, some of the language used in the Senate Report is more consistent with the majority view.

An argument can be made, however, that other language used in the Senate Report is more consistent with the minority view. For example, in describing loss causation, the Senate Report states that the plaintiff would have to prove that the defendant's fraud caused "the price at which the plaintiff bought the stock" to be "artificially inflated." If this is all that any plaintiff need prove, then the majority view is too strict because under the majority view, plaintiffs who use post-transaction investment value to measure recoverable loss must also prove that the defendant's fraud caused the post-transaction change in the value of the investment. Thus, while some of the language used in the Senate Report supports the majority view, other language supports the minority view. On balance, however, the Senate Report favors the majority view because the Senate Report as a whole illustrates Congress's intention to curtail the number of frivolous securities suits. This is more in line with the majority view because a plaintiff's burden of proof is higher under the majority view.

The actual provisions of the PSLRA also favor the majority view. When section 21D(b)(4) of the 1934 Act (added by the PSLRA) is read in conjunction with section 105 of the PSLRA and section 21D(e) of the 1934 Act (added by the PSLRA), a strong argument can be made that the PSLRA advocates the majority view. Although section 105 of the PSLRA does not pertain to Rule 10b-5 litigation,
examining section 105 is appropriate because it provides a more complete understanding of what the PSLRA meant by the term “loss causation.” Section 105 specifically states:

(b) Loss Causation
   In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.333

Thus, section 105 places the loss causation burden on the defendant and discusses loss causation in terms of a defendant’s right to reduce his liability by demonstrating that intervening factors were responsible for an investment’s decline in value.334 Reading section 21D(b)(4) in conjunction with section 105 leads to the conclusion that the plaintiff in a Rule 10b-5 private action would have the burden of proving that intervening factors were not responsible for the alleged loss.335 In other words, the plaintiff would have to prove that the defendant’s fraud directly caused the alleged loss. This reflects the language of direct causation under the majority view.

Section 21D(e) also weighs in favor of the majority view. Section 21D(e) places an upward limitation on damages in Rule 10b-5 litigation. The provision specifically states:

(1) In general
   Except as provided in paragraph (2), in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception
   In any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff’s damages shall not exceed the difference between

amending section 12 was added to S. 240).
334. See id.
the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.\textsuperscript{336}

This provision challenges the practical workability of the artificial-inflation theory of loss causation.\textsuperscript{337} Even under the minority view, which would allow a plaintiff to establish loss causation by simply alleging that the defendant's fraud artificially inflated the security, damages could not be recovered if the price of the security does not actually decline, or if it declines and rebounds within a 90-day period.\textsuperscript{338} Although the provision does not require a plaintiff who uses post-transaction investment value to measure recoverable loss to prove that the defendant's fraud caused the post-transaction loss, the provision does restrict the recovery for such a plaintiff to the amount of the post-transaction loss. If the plaintiff's recovery cannot exceed the amount of the post-transaction loss, then the plaintiff should arguably have to prove that the defendant's fraud caused that post-transaction loss, which is exactly what the majority view requires.

Despite acknowledging that the new damages provision represents a political judgment that plaintiffs should bear the risks of post-transaction price fluctuations, one scholar contends:

The issue is the extent to which that misrepresentation or omission created a disparity between the plaintiff's transaction price and the actual value of securities—on the date of the transaction. . . . After, but only after, the disparity between the transaction price and the actual value of the security on the date of the transaction is calculated, should the parties and their expert consider the impact of the “cap” on that otherwise accurate measure.\textsuperscript{339}

Thus, an argument can be made that the minority view is not affected by the new damages rule because a plaintiff who uses post-transaction investment value to measure recoverable loss can still assert that the actual injury took place at the time of the transaction and therefore such a plaintiff should arguably only have to establish a connection between the defendant's fraud and the artificial transaction price. According to this interpretation of the damages provision, the new damages formula does nothing more than provide courts with a general method for approximating what the value of the security would have been at the time of the transaction in the absence of the defendant's fraud.\textsuperscript{340}

But even if the new damages formula is viewed in this way and a

\textsuperscript{337} See Berger & Buckser, supra note 16, at 479.
\textsuperscript{338} See id.
\textsuperscript{339} Kaufman, Damages, supra note 94, § 1B:07, at 18 (1997).
\textsuperscript{340} See id. § 1B:06, at 11-12.
post-transaction price decline represents nothing more than evidence of an artificial transaction price, the plaintiff should still have to prove that the defendant’s fraud caused the post-transaction price decline.\footnote{See generally Berger & Buckser, supra note 16, at 479 (stating that “the practical viability of the ‘artificial inflation’ theory of loss causation may be called into doubt by the enactment of the PSLRA”).} If the defendant’s fraud had nothing to do with the post-transaction price decline, then a plaintiff should not be allowed to use the price decline as evidence of the true value of the investment at the time of the transaction. The new damages provision limits the amount of recovery to the amount of the post-transaction price decline; therefore, the plaintiff should always have to prove that the post-transaction price decline was caused by the defendant’s fraud even if the plaintiff is simply using the decline as evidence of transaction-based loss. If the defendant’s fraud did not cause the post-transaction price decline, it would make no sense to allow the plaintiff to use it as evidence for recovery. Thus, both the legislative history and the specific provisions of the PSLRA support the majority view.

Although a number of credible arguments can be made in favor of the minority conception of loss causation,\footnote{See supra notes 325-26, 339-40 and accompanying text.} the arguments made in support of the majority view are more convincing in light of the PSLRA.\footnote{See supra notes 316-24, 327-38 and accompanying text.} Therefore, in order to satisfy the loss causation requirement, a plaintiff who uses post-transaction investment value to measure recoverable loss should have to prove that the defendant’s fraud caused the post-transaction change in the value of the investment. But one question still remains: which of the three majority approaches is best suited for loss causation analysis?

One of the primary areas of difficulty in loss causation analysis involves distinguishing between price declines attributed to general market conditions and price declines attributed to a defendant’s fraud. Because majority-view plaintiffs can recover only when price declines are attributed to a defendant’s fraud, courts must be able to ascertain the difference.\footnote{See supra Part II.C.} Furthermore, while majority-view courts have not required plaintiffs to prove that their injury was exclusively caused by the defendant’s fraud, they have required plaintiffs to prove that their injury was substantially caused by the defendant’s fraud.\footnote{See, e.g., Robbins v. Koger Properties, Inc., 116 F.3d 1441, 1447 (11th Cir. 1997) (holding that “the plaintiff need not show the defendant’s act was the sole and exclusive cause of the injury he has suffered; he need only show that it was substantial, i.e., a significant contributing cause” (quoting Bruschi v. Brown, 876 F.2d 1526, 1531 (11th Cir. 1989) (internal quotations omitted))).} Thus, in situations where price declines are the result of a combination of general market conditions and the defendant’s fraud, courts need to be able to determine whether the bulk of the loss was caused by the
market conditions or the defendant's fraud.\textsuperscript{346}

The direct causation approach attempts to make the distinction between price declines resulting from general market conditions and price declines resulting from the defendant's fraud by requiring a plaintiff to prove that the price decline was not attributed to intervening factors.\textsuperscript{347} The first problem with such a requirement is that proving a negative is very difficult. While it would be appropriate for a defendant to point out intervening factors as a defense, it would be inappropriate to require a plaintiff to prove the absence of intervening factors.\textsuperscript{348} The number of potential intervening factors is virtually limitless.

Direct causation is also troubling because in certain circumstances it overstates the test for loss causation.\textsuperscript{349} For example, in \textit{Marbury}'s dissent, Judge Meskill's strict adherence to the direct causation approach led him to an unjust and unsympathetic conclusion.\textsuperscript{350} Judge Meskill argued that the plaintiffs failed to establish loss causation because the defendant's misrepresentations as to his qualifications as a broker did not directly cause the depreciation in the market value of the investments he promoted.\textsuperscript{351} Even though Judge Meskill shared in the majority's condemnation of the defendant's misconduct,\textsuperscript{352} he contended that the plaintiffs were not entitled to damages because the chain of causation was severed by supervening events.\textsuperscript{353} Despite the fact that common notions of fairness supported the plaintiffs' claim for relief, Judge Meskill concluded that they should have been denied recovery.\textsuperscript{354} Thus, the direct causation approach can sometimes be overly stringent and unyielding.

The foreseeability approach, on the other hand, is a more flexible

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\item[346.] See, e.g., Medline Indus., Inc. v. Blunt, Ellis & Loewi, Inc., No. 89-C4851, 1993 WL 13436, at *12 (N.D. Ill. Jan. 21, 1993) (finding that while market forces probably contributed to the plaintiffs' injury, the plaintiffs established loss causation because they proved that their losses also stemmed from the misrepresented risky nature of the investment).
\item[347.] For a discussion of the direct causation approach, see supra Part II.C.1.a.
\item[348.] This fact might explain why section 105, which places the loss causation burden on defendants in section 12(a)(2) actions, discusses loss causation in terms of a defendant's right to reduce his liability by proving that an intervening cause was responsible for the decline in the value of the investment. See supra note 333 and accompanying text. Whereas section 21D(b)(4), which places the loss causation burden on plaintiffs in Rule 10b-5 private actions, discusses loss causation without any reference to intervening causes and simply states that a plaintiff must prove that the defendant's fraud caused the alleged loss. See supra notes 265, 315 and accompanying text.
\item[349.] See supra note 217 and accompanying text.
\item[350.] See Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716-17 (2d Cir. 1980) (Meskill, J., dissenting); supra notes 191-94 and accompanying text.
\item[351.] See \textit{Marbury}, 629 F.2d at 717; supra notes 191-94 and accompanying text.
\item[352.] See \textit{Marbury}, 629 F.2d at 717.
\item[353.] See \textit{id.} at 722; supra notes 191-94 and accompanying text.
\item[354.] See \textit{Marbury}, 629 F.2d at 722-23; supra notes 191-94 and accompanying text.
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approach to loss causation. Under the foreseeability approach, courts focus on foreseeability and not on chains of causation or intervening events.\textsuperscript{355} Courts applying the foreseeability approach attempt to distinguish between price declines resulting from general market conditions and price declines resulting from the defendant’s fraud by requiring a plaintiff to prove that the price decline was a reasonably foreseeable consequence of the defendant’s fraud.\textsuperscript{356}

The problem with the foreseeability approach is that it sometimes understates the test for loss causation.\textsuperscript{357} For example, in \textit{Bastian}, despite acknowledging that the plaintiffs’ loss causation burden would have been satisfied under a test of foreseeability,\textsuperscript{358} the district court ruled that the plaintiffs had failed to establish loss causation.\textsuperscript{359} The district court refused to adopt foreseeability analysis because it considered such analysis an oversimplification of the loss causation issue.\textsuperscript{360} The district court’s decision was consistent with common notions of fairness because the decline in value of the plaintiffs’ investment was not related to a risk that the defendants had concealed, but to an industry-wide collapse, which was a risk that the plaintiffs had assumed.\textsuperscript{361} Therefore, while the foreseeability approach is appropriate in situations similar to \textit{Marbury}, it is inappropriate in situations such as \textit{Bastian} because it does not make a clear enough distinction between losses that stem from the defendant’s fraud and losses that stem from general market conditions.

The last majority-view approach to critique is the materialization-of-the-risk approach. The materialization-of-the-risk approach attempts to make a distinction between price declines resulting from general market conditions and price declines resulting from the defendant’s fraud by requiring a plaintiff to prove that the defendant’s fraud was responsible for an undisclosed risk that materialized and caused the post-transaction loss.\textsuperscript{362} Such an approach is well-suited for loss causation analysis because securities fraud inherently involves all forms of risk. Furthermore, out of the three approaches, the materialization-of-the-risk approach does the best job of analyzing the specific causes for a plaintiff’s loss. Separating the risks at the time of

\textsuperscript{355} For a discussion of the foreseeability approach, see supra Part II.C.1.b.
\textsuperscript{356} See supra Part II.C.1.b.
\textsuperscript{357} See, e.g., \textit{Bastian v. Petren Resources Corp.}, 681 F. Supp. 530, 534-36 (N.D. Ill. 1988) (holding that the foreseeability approach oversimplifies loss causation analysis and dismissing the plaintiffs’ complaint for failure to establish loss causation).
\textsuperscript{358} See id. at 534 n.3.
\textsuperscript{359} See id. at 534-36.
\textsuperscript{360} See id. at 534 & n.3, 535.
\textsuperscript{361} See \textit{Bastian v. Petren Resources Corporation}, 892 F.2d 680, 685 (7th Cir. 1990); supra notes 208-12 and accompanying text.
\textsuperscript{362} For a discussion of the materialization-of-the-risk approach, see supra Part II.C.1.c.
the transaction into undisclosed risks and general market risks makes it easier to pinpoint the source of a plaintiff's post-transaction loss.

The materialization-of-the-risk approach also does the best job of balancing the interests of plaintiffs and defendants. For example, in Bastian, the Seventh Circuit appropriately ruled that the plaintiffs' had not established loss causation because their loss was caused by an industry-wide collapse, which was a risk that they had assumed at the time of the transaction. As discussed above, the district court in Bastian refused to apply a foreseeability analysis because such an analysis produced an outcome that was too plaintiff-friendly. On the flip side, in Broderick, a district court applying the materialization-of-the-risk approach held that the plaintiff had established loss causation because the defendant's fraud subjected the plaintiff to an undisclosed risk at the time of the transaction and the plaintiffs' injury was caused by the materialization of that undisclosed risk. Although Marbury involved a similar fact pattern, the dissent's strict adherence to the direct causation approach led it to an unjust conclusion in favor of the defendant. Thus, the materialization-of-the-risk approach strikes a fair balance between the plaintiff-friendly foreseeability approach and the defendant-friendly direct causation approach.

Because the materialization-of-the-risk approach enables courts to strike such a balance, it is the approach that is most consistent with the legislative history of the PSLRA. Although the PSLRA was designed to make it more difficult for plaintiffs to file frivolous securities suits, it was not designed to prevent true victims of securities fraud from bringing valid claims against fraudulent violators of securities laws. In the words of the Senate Report, "[i]n crafting this legislation, ... [Congress] has sought to strike the appropriate balance between protecting the rights of victims of securities fraud

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363. See, e.g., Bastian, 892 F.2d at 685 (holding that the plaintiffs did not establish loss causation because their loss was not caused by the defendant's fraud, but by an industry-wide collapse); Broderick v. Menconi, No. 88-C 0161, 1990 WL 51180, at *2 (N.D. Ill. Apr. 12, 1990) (concluding that the plaintiffs established loss causation because the defendant misrepresented the risky nature of the investment and it was the risky nature of the investment that caused the plaintiffs' loss); supra notes 208-12, 224-27 and accompanying text (discussing Bastian and Broderick); see also Steckman & Conner, supra note 16, at 458-59 (asserting that courts relying on Bastian have generated "both defense and plaintiff-friendly cases").
364. See Bastian, 892 F.2d at 685; supra notes 208-12, 361 and accompanying text.
365. See Bastian v. Petren Resources Corporation, 681 F. Supp. 530, 534 (N.D. Ill. 1988); supra notes 358-60.
366. See Broderick, 1990 WL 51180, at *1-*2 (N.D. Ill. Apr. 12, 1990); supra notes 224-27 and accompanying text.
367. See Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716-17 (2d Cir. 1980) (Meskill, J., dissenting); supra notes 191-94, 350-54 and accompanying text.
368. See supra Part III.
and the rights of public companies to avoid costly and meritless litigation.\footnote{370} Of the three majority-view approaches, the materialization-of-the-risk approach does the best job at striking this “appropriate balance”;\footnote{371} therefore, the legislative history of the PSLRA most supports the materialization-of-the-risk approach.

In conclusion, there are four convincing reasons why the materialization-of-the-risk approach is the best approach for loss causation analysis. First, it adheres to the majority view of loss causation, which is supported by both the legislative history and provisions of the PSLRA.\footnote{372} Second, it provides the best analytical means for pinpointing the source of a plaintiff’s post-transaction loss.\footnote{373} Third, it strikes the fairest balance between the interests of plaintiffs and defendants.\footnote{374} Finally, it produces results that are directly in line with the goals that Congress set for the PSLRA.\footnote{375} Thus, the materialization-of-the-risk approach is the winning approach to loss causation.

CONCLUSION

The PSLRA has provided the foundation for developing a uniform approach to loss causation. Although the PSLRA does not explicitly resolve the loss causation controversy, it does subject the various incarnations of loss causation to a central authority. Furthermore, when the PSLRA is examined in conjunction with Rule 10b-5 case law, the materialization-of-the-risk approach, which adheres to the majority view of loss causation,\footnote{376} emerges as the model approach to loss causation.

The materialization-of-the-risk approach requires plaintiffs to prove that their loss was caused by the materialization of a risk that was undisclosed at the time of the transaction because of the defendant’s fraud.\footnote{377} Analyzing loss causation in such a way has consistently produced equitable results for both plaintiffs and defendants,\footnote{378} and thus the materialization-of-the-risk approach should be used by all courts as the standard means for loss causation analysis. Uniform utilization of the materialization-of-the-risk approach would greatly diminish the amount of inconsistency, uncertainty, and injustice in

\footnote{371} See supra notes 363-67 and accompanying text.
\footnote{372} See supra notes 316-43 and accompanying text.
\footnote{373} See supra note 362 and accompanying text.
\footnote{374} See supra notes 363-67 and accompanying text.
\footnote{375} See supra notes 368-71 and accompanying text.
\footnote{376} Under the majority view, a plaintiff who uses post-transaction investment value to measure recoverable loss must establish a connection between the post-transaction investment value and the defendant’s fraud. See supra Part II.C.
\footnote{377} See supra Part II.C.1.c.
\footnote{378} See supra notes 363-67 and accompanying text.
Rule 10b-5 securities litigation and would finally close the chapter on loss causation's long history of turmoil and confusion.