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The "In-and-Out" Trader and Loss Causation In Securities Fraud Litigation

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At the time it was issued in April 2005, the Supreme Court's decision in *Dura* was heralded as a seminal decision clarifying the requirements for pleading and proving "loss causation," or the causal relationship between alleged corporate misrepresentations and investors' losses, in securities fraud lawsuits.[1] Now, a year and a half later, courts are once again split on several loss causation issues that the *Dura* decision left unanswered.

Prominent among those issues is the treatment of so-called "in-and-out" stock traders for purposes of pleading and proving loss causation. In-and-out traders are investors who both purchased and sold stock during the alleged class period and thus arguably exited the investment prior to the public revelation of the alleged fraud. This article discusses several of the key issues presented by in-and-out traders and illustrates the significant ramifications these issues could have in determining the potential damages and, hence, the settlement value in any securities fraud class-action litigation.

The *Dura* Decision

To prevail on a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, a plaintiff must plead and later establish that the defendant made a false statement or omission of material fact with *scienter* — *e.g.*, a wrongful state of mind — in connection with the purchase or sale of a security, upon which the plaintiff reasonably relied (this is sometimes referred to as "transaction causation" and is akin to the common-law-fraud element of reliance), which proximately caused the economic loss for which the plaintiff seeks to recover damages (this element was codified for the first time in the Private Securities Litigation Reform Act of 1995.

It is this last element, commonly referred to as loss causation, that was the subject of much uncertainty until the Supreme Court finally attempted to clarify the matter. In *Dura* the plaintiff investors alleged that Dura Pharmaceuticals and several of its officers made a number of materially false statements between April 15, 1997, and Feb. 24, 1998, regarding the prospects for Food and Drug Administration approval of an asthmatic spray device the company was developing. In a Feb. 24, 1998, statement (which did not focus on the asthmatic spray device) Dura announced that its earnings would be lower than expected, principally due to slow drug sales. The next day, the company's stock price fell nearly 50 percent. Eight months later, in November 1998, the company announced that the FDA would not approve the asthmatic spray device. The stock-price reaction to the November 1998 announcement was negligible.

Against this backdrop the District Court dismissed the action, finding that the plaintiffs had failed to satisfactorily plead the loss-causation element, given that the Feb. 24, 1998, announcement did not even mention the asthmatic spray device. Rather, the District Court found that the decline in the stock price (*i.e.*, the investors' losses) was caused by the unexpected earnings shortfall, as opposed to any false statements regarding the asthmatic spray device.

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Rejecting the view of virtually all other circuit courts to consider the issue, the U.S. Court of Appeals for the 9th Circuit reversed and held that the loss-causation element does not require a showing that the stock price dropped following a corrective disclosure. The 9th Circuit held that where an efficient market exists for the trading of the security at issue — this includes the common stock of most companies trading on the New York Stock Exchange, the American Stock Exchange or NASDAQ — the loss-causation element may be satisfied simply by alleging (and, at trial, establishing) that the stock "price on the date of purchase was inflated because of the misrepresentation." The 9th Circuit reasoned that the injury occurs at the time of the purchase, which is the time at which "damages are to be measured."

In the wake of the 9th Circuit's ruling in *Dura*, a number of commentators noted that the decision threatened to eviscerate the loss-causation element, especially at the pleading stage. As a practical matter, almost all securities fraud cases allege that the defendants made misleading statements that caused the stock to trade at artificially inflated levels. According to the 9th Circuit, that alone should have been sufficient to satisfy the loss-causation element without any allegation that the stock decline was causally related in any way to the allegedly false statements.

The Supreme Court decision in *Dura* rejected the 9th Circuit's view that the loss-causation element may be satisfied simply by alleging that the stock price was inflated at the time of the plaintiff's purchase, finding it directly contrary to the PSLRA "which expressly imposes on plaintiffs the burden of proving that the defendant's misrepresentations caused the loss for which the plaintiff seeks to recover."

The Supreme Court held that "normally … an inflated stock price will not itself constitute or proximately cause the relevant economic loss." The court noted that when a purchaser subsequently resells shares at a lower price "the lower price may reflect, not the earlier misrepresentation, but changed circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events which, taken separately or together, account for some or all of that lower price."

Although the Supreme Court strongly rejected the 9th Circuit's view on loss causation, it did not expressly articulate any single standard for alleging and establishing loss causation. It did, however, provide guidance. In particular, the high court noted "the complaint's failure to claim that Durat's share price fell significantly after the truth became known." The court also noted that "the complaint nowhere else provides the defendants with notice of what the relevant economic loss might be or of what the causal connection might be between that loss and the misrepresentation" at issue. Finally, the court noted that the PSLRA evinced Congress' intent to permit private securities fraud actions to proceed only where "plaintiffs adequately allege and prove the traditional elements of causation and loss."

Issues Presented by In-and-Out Traders

In the wake of the Supreme Court's decision in *Dura*, courts have generally strictly adhered to *Dura*'s mandate, requiring that plaintiffs in securities fraud lawsuits adequately plead (and later establish) a causal connection between the alleged misrepresentation and any subsequent stock-price drop. The Supreme Court's decision in *Dura*, however, left unresolved several key loss causation issues.[2] Perhaps most notably, courts have struggled with the issue of how to treat in-and-out stock traders for purposes of pleading and proving loss causation.

This issue was not addressed in *Dura* because that decision expressly contemplated the classic securities fraud claim scenario in which the plaintiffs allege they bought stock at a price artificially inflated by the alleged fraud and that they held that stock until after the alleged fraud was publicly disclosed (a "corrective disclosure"). As a result, defendants (and, on occasion, plaintiffs competing to be appointed by the court as lead plaintiff) have argued that in-and-out traders cannot state a claim for securities fraud because they cannot demonstrate loss causation under *Dura*, given that such plaintiffs bought and sold their shares prior to the corrective disclosure.[3] In the post-*Dura* era, several district courts have considered the issue, but no consensus has prevailed as to whether or under what circumstances in-and-out traders are able to plead or prove loss causation.

This issue may arise at various stages during the course of a securities fraud class-action litigation, including at the earliest stages of a litigation when the court is considering whom to appoint as lead plaintiff. In addition, the issue can arise at the pleading stage where defendants (in motions to dismiss) often argue for the dismissal of any members of the class to the extent that they traded "in-and-out" prior to the corrective disclosure, at the class-certification stage and, of course, at the summary-judgment and trial phases of the litigation.

The stakes in the debate over in-and-out traders are enormous as they directly impact the defendants' potential exposure and, therefore, the settlement value of any securities fraud class-action litigation. For example, assume that the plaintiffs allege a three-year class period, and that the first alleged corrective disclosure occurs at

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the conclusion of the alleged class period, as is often the case. In such circumstances, it would appear under *Dura* that the only class members that could potentially state a claim are those stockholders that purchased stock during the class period and were still holding that stock on the final day of the class period. Stated differently, despite the alleged three-year class period in this example, only those stockholders still holding their stock at the time of the corrective disclosure (*i.e.*, the final day of the class period) would have a potentially viable claim, assuming all the other elements of a Rule 10b-5 claim are met.

A May 2006 class-certification decision from the U.S. District Court for the Northern District of California illustrates precisely this point. In *In re CornerStone*, the plaintiffs alleged that beginning July 29, 1998, CornerStone, a retail marketer of propane products, and several of its officers made materially false statements and omissions regarding CornerStone's financial results and business prospects.[4] As alleged in the complaint, the first revelation (or partial disclosure) of CornerStone's financial instability occurred July 27, 2001, when CornerStone issued a press release announcing a reduction in the company's dividends in order to address its high level of debt. Following this disclosure, the company's stock declined by approximately 45 percent. According to the complaint, following the July 2001 press release, CornerStone continued to reveal the company's difficulties in piecemeal fashion for another year and a half until Feb. 10, 2003, when the company announced it would restate certain of its prior financial statements.

Based on the facts, the plaintiffs moved to certify a class consisting of individuals or entities that acquired CornerStone stock between July 29, 1998, and Feb. 11, 2003. The defendants argued that any certified class should exclude any individuals or entities who sold their shares prior to the end of the class period, arguing that any such in-and-out traders cannot demonstrate loss causation under *Dura* because they sold prior to the corrective disclosure. In response, the plaintiffs argued that loss causation was a premature "damages" issue not ripe for consideration at the certification stage.

Siding with the defendants, the District Court noted that, while loss causation is highly relevant in determining the amount of potential damages and thus the value of the lawsuit, it is also relevant under *Dura* as a threshold matter "in establishing whether a securities fraud claim has been adequately [pleaded]." The court then reviewed the complaint's allegations and found that the earliest potential corrective disclosure occurred with the issuance of the July 2001 press release (which was earlier than the February 2003 date urged by the defendants). As a result, the court excluded from certification all in-and-out traders that sold their shares prior to the July 2001 release. The court said, "Here, since corrective disclosure is alleged to have occurred only from July 2001 onward, under *Dura* there can be no loss causation for plaintiffs who purchased and sold stock at the inflated price prior to that disclosure and, thus, these [in-and-out] plaintiffs may not recover at all … and are excluded from the definition of the class."

Thus, *In re CornerStone* — in which the court excluded from the certified class any individual or entity who purchased CornerStone stock in the first three years of the class period (July 1998 through July 2001) if they sold that stock during that three-year period — demonstrates the enormous ramifications that the issue of in-and-out traders can have in determining the potential damages and hence the settlement value of any securities class-action litigation.

While other courts have also strictly applied *Dura* in holding that in-and-out traders cannot prove loss causation and are therefore unable to state a claim under Rule 10b-5,[5] some courts have been less rigorous (at least at the class-certification phase of litigation) in applying the teachings of *Dura* to in-and-out traders.

For example, in *In re BearingPoint* — a January 2006 decision in the U.S. District Court for the Eastern District of Virginia — the plaintiffs alleged that BearingPoint, a provider of consulting and systems integration services, had made materially misleading statements during the period of Aug. 14, 2003, to April 20, 2005, regarding the company's historical financial results.[6] BearingPoint issued a corrective disclosure April 20, 2005, in reaction to which the company's stock-price dropped 32 percent. The complaint also alleged that during the final six months of the alleged class period (specifically, between Nov. 17, 2004, and March 18, 2005) BearingPoint had made three filings with the Securities and Exchange Commission in which BearingPoint acknowledged actual or potential problems with its internal financial controls. According to the court, in each of these three instances, the market "ignored" the news and the company's stock price either increased or dropped "quite modestly."

Against this backdrop and prior to trial, the plaintiffs moved to certify a class consisting of all individuals or entities that acquired BearingPoint stock "between Aug. 14, 2003, and April 2005, and who were damaged thereby." In opposing class certification, the defendants cited *Dura* and argued that the predominance standard for certifying class actions (in which a court must determine whether questions of law or fact common to the class will predominate over any questions affecting only individual

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members) was not met because of the predominance of the individual issue of whether in-and-out traders of BearingPoint stock can prove loss causation.

After noting that the issue of "[w]hether in-and-out traders … can show loss causation is a somewhat *novel issue*," the court ultimately determined that "because in-and-out traders may conceivably prove loss causation, they are appropriately counted as members of the proposed class." Significantly, in arriving at this decision, the court did not conclude or rule that the in-and-out traders had in fact satisfactorily established loss causation and, therefore, an entitlement to recover damages. Rather, focusing on the issue of whether the in-and-out traders could conceivably prove loss causation later at trial, the court held that such a showing was conceivable. In so holding, the court relied on two factors. First, in an apparent reference to the three disclosures during the final six months of the alleged 21-month class period, the court noted that there had been multiple partially corrective disclosures during the class period. The court did not explain why that fact should permit traders who were in-and-out of the stock during the first 15 months of the class period (*i.e.*, prior to the onset of the partially corrective disclosures) to remain in the class period. Second, the court noted with virtually no discussion that "it is also conceivable that the inflationary effect of a misrepresentation might well diminish over time, even without a corrective disclosure, and thus in-and-out traders in this circumstance would be able to prove loss causation." The court provided no guidance as to what concrete factors it would propose to look to in determining that the inflationary effect of a misrepresentation "may well" have diminished over time, even prior to any partially corrective disclosure. Nor did the court explain how this concept could be squared with the express language of the PSLRA, which, according to the Supreme Court in *Dura* "expressly imposes on plaintiffs the burden of proving that the defendant's misrepresentations caused the loss for which the plaintiff seeks to recover."

Conclusion

While it would appear that the PSLRA and *Dura* dictate that in-and-out traders who sell before any corrective disclosures are made cannot state a viable claim for securities fraud under Rule 10b-5, the high-stakes debate regarding in-and-out traders persists and awaits a judicial consensus, if not a definitive ruling from the Supreme Court.

Notes

[1] *Dura Pharmaceuticals Inc. v. Broudo*, 125 S. Ct. 1627 (2005).

[2] *See, e.g., In re Initial Public Offering*, 399 F. Supp. 2d 261 (S.D.N.Y. 2005), (noting that "*Dura* itself does not define a pleading standard for loss causation; rather, it simply rejects the 9th Circuit's standard as overly permissive").

[3] *Compare In re Bally Total Fitness Securities Litigation*, 2005 WL 627960 (N.D. Ill. 2005), (refusing to appoint an in-and-out trader as lead plaintiff because of the burden it would have proving that "even though it was an in-and-out trader, its losses nevertheless were caused by the alleged fraudulent statements") *with Montoya v. Mamma.com Inc.*, No. 05 Civ. 2313, 2005 WL 1278097 (S.D.N.Y. May 31, 2005), (appointing an in-and-out trader as lead plaintiff).

[4] *In re CornerStone Propane Partners. L.P. Securities Litigation*, 2006 WL 1180267 (N.D. Cal. May 3, 2006).

[5] *See, e.g., In re Compuware Securities Litigation*, 386 F. Supp. 2d 913 (E.D. Mich. 2005), (relying on *Dura* and granting summary judgment to defendants in securities fraud class-action litigation because the named plaintiff was an in-and-out traderthat had sold its stock prior to the corrective disclosure).

[6] *In re BearingPoint Inc. Securities Litigation*, 232 F.R.D. 534 (E.D. Va. 2006).

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