
Laurence A. Steckman
Robert E. Conner
Kris Steckman Taylor

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LOSS CAUSATION, ECONOMIC LOSS RULES AND OFFSET DEFENSES—DISMISSAL MOTION PRACTICE AFTER ACTICON A.G. V. CHINA NORTH EAST PETROLEUM HOLDINGS LTD.

Laurence A. Steckman*
Robert E. Conner**
Kris Steckman Taylor***

I. INTRODUCTION

In Acticon A.G. v. China North East Petroleum Holdings Lim-

* Laurence A. Steckman is a partner in the law firm Eaton & Van Winkle LLP in New York City and has been a member of the Board of Advisors of the Private Securities Litigation Reform Act of 1995 and Reporter since 1996. In July, 2006, Super Lawyers Magazine, in its premiere New York edition, identified Mr. Steckman as one of New York's “Super Lawyers” in securities and business litigation. He received this honor once again in 2013. Mr. Steckman received his masters degree in philosophy from Columbia University where he was a doctoral candidate prior to receiving his law degree, with honors, from Touro Law School. He has practiced law for more than twenty-five years and has written extensively on legal and economic causation and damages theory. He is the author or lead co-author of more than forty published works on the law.

** Robert E. Conner is a founding member of Thornapple Associates, Inc., which is now in its 31st year of providing expert consulting services and testimony in investment and commercial disputes. Mr. Conner has provided expert services in more than 800 disputes. He is a graduate of Harvard Business School and Harvard’s John F. Kennedy School of Government, with Ph.D. studies at Harvard and M.I.T. in economics, statistics and government. He has authored or co-authored twenty-six investment and law articles related to securities disputes. Thornapple has provided services to the S.E.C., I.R.S., State Attorneys General and Banking and Securities Commissioners. He has taught graduate level statistics and finance.

*** Kris Steckman Taylor is an attorney, an investment banking professional and Counsel to Tigress Financial Partners, a New York-based Broker-Dealer and Boutique Investment Bank which he helped found and where he is a Registered Principal. He has published on predictive models and holds FINRA Series 7, 24, 52, 53, 63, 87, and 99 licenses. Mr. Taylor acts as a litigation consultant for Borgers & Associates, with a focus on helping institutional investors recover for investments in defective RMBS and other asset-backed securities. Mr. Taylor graduated from the Honors Program at the University of Tampa with a BA in Political Science, and received his Juris Doctorate from Pepperdine University School of Law, where he was an editor of the Business Law Review. He is a member of the New York State Bar.
The Second Circuit clarified several issues regarding the pleading of loss causation and application of the second investment rule defense in Rule 10b-5 class suits. The precise issue, as framed by the Second Circuit, was “whether the fact that a stock’s share price recovered soon after the fraud became known defeats an inference of economic loss.”

It ruled that price recovery does not defeat an inference of economic loss:

[A] share of stock that has regained its value after a period of decline is not functionally equivalent to an inflated share that has never lost value. . . . [I]t is improper to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud if the stock recovers for completely unrelated reasons. Such a holding would place the plaintiff in a worse position than he would have been absent the fraud.

The Second Circuit concluded an offset rule, such as the one it rejected, would deprive an investor of the benefits of a “second investment decision” to refrain from selling a security, notwithstanding a corrective disclosure of fraud, and the opportunity to make a determination as to whether to continue holding that investment, based on its non-fraudulent, remaining merits:

In the absence of fraud, the plaintiff would have purchased the security at an uninflated price and would have also benefitted from the unrelated gain in stock price. If we credit an unrelated gain against the plaintiff’s recovery for the inflated purchase price, he has not been brought to the same position as a plaintiff who was not defrauded because he does not have the opportunity to profit (or suffer losses) from “a second investment decision unrelated to his initial decision to purchase the stock.”

The Second Circuit vacated the district court order dismissing the complaint, holding: “the fact that the price of the stock recovered

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1 692 F.3d 34 (2d Cir. 2012).
2 Id. at 35-36.
3 Id. at 41.
4 Id. (quoting Harris v. Am. Inv. Co., 523 F.2d 220, 228 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976)).
soon after the price dropped does not negate an inference of economic loss and loss causation at the pleading stage.”

While noting that the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo* had considered pleading standards of economic loss and loss causation together, the Second Circuit held that the price fluctuations at issue in *Acticon* would not rebut an inference of economic loss, under either standard. It rejected what it called an “economic loss rule” upon which several district courts had relied in dismissing Rule 10b-5 securities cases.

In *Malin v. XL Capital Ltd.*, for example, the district court held:

> [A] price fluctuation without any realization of an economic loss is functionally equivalent to the Supreme Court’s rejection of an artificially inflated purchase price alone as economic loss. If the current value is commensurate to the purchase price, there is no loss, regardless of whether the purchase price was artificially inflated. Thus, under the circumstances, Plaintiffs’ allegations of an economic loss are insufficient when considered in conjunction with the evidence of price recovery.

Relying on *Malin*, the district court in *Ross v. Walton* explained and held:

> Analogous to *Malin*, Plaintiffs here argue that all they need to allege is a facially plausible price drop caused by the misrepresentation. However, the Court is unaware of any authority in which actual economic loss was found when the stock value returned to pre-disclosure prices and could have been sold at a profit just after the class period. It appears undisputed that on at least three occasions in June 2007 each Plaintiff

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5 *Id.* at 41.
7 *Acticon*, 692 F.3d at 38.
8 *Id.* at 40.
10 *Id.* at *4* (emphasis added).
could have sold the stock at a profit. The Court agrees with Defendants that, while a sale of stock is not necessary, if the stock’s value was commensurate to the pre-disclosure trading price after the close of the class period [and] could have been sold at a profit, the “actual economic loss” contemplated in *Dura* is precluded. Further, *Dura* requires that a plaintiff show that it was this revelation that caused the loss and not one of the “tangle of factors” that affect price. Plaintiff’s argument that Section 21D(e) provides a presumption of a causal connection is misplaced. Any conclusion otherwise would “automatically supply the causation element to all securities plaintiffs,” contravene *Dura* which mandates a judicial inquiry into the causation element.12

In *In re Veeco Instruments, Inc. Securities Litigation*, another district judge, citing *Malin*, held: “[P]laintiffs who chose to retain their shares past the point when the . . . shares were purchased, can prove no economic loss that is attributable to any of the defendants’ alleged misrepresentations.”14

The *Malin* court’s concept of “functional equivalence” was referenced, but not well explicated, by the Second Circuit in its decision.15 A clear understanding of why the “economic loss rule” was rejected is important in understanding how the Second Circuit currently views loss causation-based motion practice in Rule 10b-5 class suits, when the stock price of affected securities has recovered to pre-corrective disclosure levels.16 Acticon clarified in important ways the Second Circuit’s view on the relationship between the second investment rule and loss causation in motion practice under the Private Securities Litigation Reform Act of 1995 (“Reform Act” or

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12 Id. at 42-43.
14 Id. at *7.
16 Id.
II. **IN RE CHINA NORTH EAST PETROLEUM HOLDINGS LTD. SECURITIES LITIGATION**

A. **The District Court’s View of the Case**

In the district court, Acticon was lead plaintiff in consolidated class suits against China North East Petroleum Holdings Ltd. (“NEP”) claiming NEP misled investors and that the wrongdoing was revealed through several NEP corrective disclosures. NEP’s stock price dropped on the trading days following each such disclosure, but rebounded above Acticon’s average purchase price on twelve days within the final two calendar months of the 90-day period following the final corrective disclosure. The defense argued Acticon could have sold at several times and recovered all the money it claimed to have lost and, because it had failed to do so, under *Malin* and its progeny, plaintiffs lacked recoverable damages for failure to properly plead loss causation.

District Judge Cedarbaum began her analysis by reasoning that since *Dura*, courts, as a matter of law, have held that a purchaser who holds stock to a point where its post-disclosure price has risen above the purchase price suffers no economic loss and that this is true even if the price fell following a corrective disclosure. Judge Cedarbaum further stated that *Malin* had quoted *Dura* in dismissing a complaint brought by securities purchasers who chose not to sell at a profit, following a corrective disclosure:

> [T]he stock price had declined in the days following the disclosure but, within sixty trading days, had recovered to exceed its pre-disclosure closing price. That post-disclosure recovery, the court held, precluded a claim for securities fraud because “a price fluctu-

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19 See Acticon, 692 F.3d at 36.
20 *Id.* at 36-37.
ation without any realization of an economic loss is functionally equivalent to the Supreme Court’s rejection of an artificially inflated purchase price alone as an economic loss.”

The Malin court, however, had actually misquoted the actual wording of Dura—specifically, Judge Dorsey wrote: “If the current value is commensurate to the purchase price, there is no loss, regardless of whether the purchase price was artificially inflated.” Dura, however, had not used the phrase “current value,” but the phrase “at that instant.” Hence, the Second Circuit faulted the Malin court, and its progeny, for “extrapolat[ing]” from Dura.

Acticon argued it should be permitted to recover losses because it sold its shares at lower prices than had prevailed in earlier months. Rejecting Acticon’s argument, Judge Cedarbaum explained and held:

[Although these sales were unquestionably at a loss, that loss cannot be imputed to any of NEP’s alleged misrepresentations. A plaintiff who forgoes a chance to sell at a profit following a corrective disclosure cannot logically ascribe a later loss to devaluation caused by the disclosure. Thus, Acticon has not suffered any loss attributable to the misrepresentations alleged in the complaint. Because the absence of economic loss is sufficient grounds for dismissal, I do not reach the other arguments offered by defendants . . . .]

Because Acticon could have sold its holdings at a profit within 90 days after NEP’s final corrective disclosure made the misrepresentations at issue public, the district court, referring to “missed opportunities,” held Acticon’s losses could not be “imputed to any of NEP’s alleged misrepresentations.” Judge Cedarbaum misconstrued Acticon’s decision not to sell at a profit when it could have done so as the direct cause of its losses; in other words, that decision, rather than the

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22 Id. at 352-53 (quoting Malin, 2005 WL 2146089, at *4).
23 Acticon, 692 F.3d at 41 (citing Malin, 2005 WL 2146089, at *4) (emphasis added).
24 Dura, 544 U.S. at 342.
25 Acticon, 692 F.3d at 40.
26 Id. at 40-41.
27 In re China, 819 F. Supp. 2d at 353.
28 Id.
corrective disclosure of defendants’ fraudulent misrepresentations, was the actual proximate cause of plaintiffs’ losses: “[a] plaintiff who forgoes a chance to sell at a profit following a corrective disclosure cannot logically ascribe a later loss to devaluation caused by the disclosure.”

In Judge Cedarbaum’s view, because Acticon, knowing its initial purchase was at an inflated price as the result of fraud and that the post-disclosure value of NEP shares could increase or decrease, could have eliminated all its damages by selling at a profit, but instead decided to retain its shares, which was the legal cause of injury. Judge Cedarbaum’s holding reflects the view that an injured party must mitigate its damages when it has the means to reasonably do so. The second investment rule, moreover, bars claims for damage when losses have resulted from a plaintiff’s voluntarily decision to undertake the investment risks associated with holding a security whose pricing has historically been or is currently affected by fraud on a going-forward basis.

However, Judge Cedarbaum’s reasoning in Acticon conflated two distinct events of separate causal origin, thereby implicitly and inappropriately netting the economic outcomes of the two unrelated events as if they were one. In consequence, Judge Cedarbaum erred in imposing an offsetting measure of damages that failed to recognize the validity of Acticon’s loss causation argument and associated measure of damages arising from the corrective disclosure of an alleged fraud. As a matter of loss causation, losses incurred as the result of a purchase or hold decision subsequent to a final corrective disclosure are not damages attributable to the preceding securities fraud, since the investor made a new “second” investment decision to expose itself to post-disclosure investment risks, a decision causally independent and uncorrelated with defendants’ misrepresentations and/or omissions of material fact.

B. The PSLRA “Bounce Back”

The PSLRA “bounce back” is not a theory of damages but a
rule designed to reasonably “cap” recoverable damages arising from the continued ownership of stock purchased prior to corrective disclosure(s). The “bounce back” provision caps damages as follows:

[T]he award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid . . . 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.

“Mean trading price” is defined as “an average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period.” The court in Acticon stated:

[I]f the “mean trading price of a security during the 90-day period following the correction is greater than the price at which the plaintiff purchased his stock then that plaintiff would recover nothing under the PSLRA’s limitation on damages.” But if the mean trading price during the 90-day period is less than plaintiff’s purchase price, plaintiff may recover out-of-pocket damages up to the difference between her purchase price and the mean trading price.

The Reform Act’s legislative history indicates Congress limited damages because it believed that “[c]alculating damages based on the date corrective information is disclosed may substantially overestimate plaintiff’s actual damages.” The provision is intended to limit damages to “those losses caused by the fraud and not by other market conditions.”

Aside from imposing the “bounce back” cap on damages, the Second Circuit observed that Congress did not otherwise disturb the

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32 See Acticon, 692 F.3d at 38-39.
35 Acticon, 692 F.3d at 39 (quoting In re Mego Fin. Corp. Sec. Litig., 213 F.3d 454, 461 (9th Cir. 2000) (emphasis omitted)).
37 Acticon, 692 F.3d at 39.
traditional out-of-pocket method. \(^{38}\) Rather than being forced to “sell to sue,” the Reform Act preserves investor freedom to make a “second investment decision” to hold such stock. \(^{39}\) Critically, that decision will not influence an investor’s ability to recover fraud-caused damages, albeit capped at the average daily closing price of the stock at issue over a 90-day period following the last corrective disclosure. \(^{40}\)

The premise underlying the Reform Act “bounce back” is that an efficient market will, over time, adjust the price of a security so it reflects the disclosure of a fraud in the market. This provides an objective basis for calculating damage equal to the difference between the average post-disclosure price and the last closing price just prior to corrective disclosure. Rather than being required to sell at a moment of heightened uncertainty as to the magnitude of the impact of the disclosed fraud on the market price of the security, investors can, instead, rely on the efficiency and transparency of the market to sort it out, an objective basis for limiting the post-disclosure measure of economic loss attributable to the fraud.

By contrast, Judge Cedarbaum held that Acticon suffered “no actionable loss” with respect to its continued holding of NEP stock and, in fact, could have turned a profit had Acticon sold its NEP stock position months after the final corrective disclosure—thereby finding the complaint failed to properly plead loss causation. \(^{41}\) She did not mention any particular damage theory, including the out-of-pocket theory or second investment rule to which the Second Circuit would refer, nor to the Reform Act bounce back provision.

C. The Second Circuit on the Error of Malin

The Second Circuit held that the district court, in granting dismissal, erred and explained at length where its analysis went astray. \(^{42}\) Namely, in its reliance on a rule set forth in Malin and sub-

\(^{38}\) *Id.*

\(^{39}\) See *In re Veeco*, 2007 WL 7630569, at *7.

\(^{40}\) *Acticon*, 692 F.3d at 38-39.

\(^{41}\) *Id.* at 37. The relevant period for the putative class action began May 15, 2008, with corrective disclosures beginning on February 23, 2010; NYSE trading of NEP stock was halted as of May 25, 2010 and did not resume trading until September 9, 2010 (marked by a 20% price drop since close of trading in May), from which date the 90-day post-disclosure trading period was measured.

\(^{42}\) *Id.* at 39-41
sequently relied upon by several other district courts in reliance:

The limitation upon damages imposed by the District Court—and by the other district court decisions upon which it relied—is inconsistent with both the traditional out-of-pocket measure for damages and the “bounce back” cap imposed in the PSLRA. This line of cases, beginning with *Malin v. XL Capital Ltd.*, holds that [in the instance of] a securities fraud plaintiff suffers no economic loss if the price of the stock rebounds to the plaintiff’s purchase price at some point after the final alleged corrective disclosure. The *Malin* court correctly noted that the fact that the price rebounded does not, at the pleading stage, negate the plaintiff’s showing of loss causation. The *Malin* court reasoned that determining why a stock’s price rebounded after an initial drop requires the court to consider “a competing theory of causation and raises factual questions not suitable for resolution on a motion to dismiss.” We agree with the *Malin* court’s analysis on this point.43

The *Acticon* defendants argued that the share price rebound, in and of itself, evidenced the market was unfazed by the alleged corrective disclosures and, therefore, the disclosures must be unrelated to Acticon’s losses.44 However, rejecting that argument, the Second Circuit held that, at the dismissal phase of litigation, the district court should not have attempted to resolve why NEP’s share price rebounded after its initial fall.45 Rather, it should have drawn all reasonable inferences in favor of Acticon, the non-moving party, and assumed the price rose for reasons unrelated to its initial drop.46 Per the Second Circuit, that is also where *Malin* got it wrong:

The *Malin* court held, however, that a rebound in stock price three months after the close of a class period negates an inference of economic loss. In reaching this holding, *Malin* and the courts following it have extrapolated from the Supreme Court’s decision in

43 Id. (quoting *Malin*, 2005 WL 2146089, at *4).
44 *In re China*, 819 F. Supp. 2d at 353.
45 *Acticon*, 692 F.3d at 41.
46 Id.
Dura. In Dura, the Court rejected the Ninth Circuit’s holding that securities fraud plaintiffs need only demonstrate “that the price on the date of purchase was inflated because of the misrepresentation.” According to the Court, “this statement of the law is wrong” because ordinarily in fraud-on-the-market cases “an inflated purchase price will not itself constitute or proximately cause the relevant economic loss.” As the Court explained, “[A]s a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value.” Moreover, the “logical link between the inflated share purchase price and any later economic loss is not invariably strong.”

The court in Acticon continued:

For example, a purchaser might “sell[ ] the shares quickly before the relevant truth begins to leak out,” with the result that “the misrepresentation will not have led to any loss.” Further, even if a purchaser sells at a lower price after a corrective disclosure is made, “that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price.” Accordingly, the Court rejected the Ninth Circuit’s approach, which “would allow recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss.”

Dura, the Second Circuit explained, did not alter the traditional out-of-pocket measure of securities damages, but clarified that under Rule 10b-5, plaintiffs who buy stock at inflated prices must still prove economic loss proximately caused by defendant’s misrep-

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47 Id. at 40 (quoting Dura, 544 U.S. at 342) (internal citations omitted).
48 Id. (quoting Dura, 544 U.S. at 342-43, 346) (internal citation omitted).
Acticon, per the Second Circuit, satisfied *Dura’s* pleading requirement because plaintiffs not only alleged they bought NEP at an inflated price, but that NEP’s stock price dropped after the fraud became known.\(^{50}\) *Malin*, in contrast, according to the Second Circuit’s analysis, adopted a “more expansive view” of *Dura*.\(^{51}\) It placed undue emphasis on the Court’s observation that: “at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at *that instant* possesses equivalent value.”\(^{52}\) The Second Circuit then identified the precise language in *Malin* that was in error as follows:

\[\text{[A] price fluctuation without any realization of an economic loss is functionally equivalent to the Supreme Court’s rejection of an artificially inflated purchase price alone as economic loss. If the current value is commensurate to the purchase price, there is no loss, regardless of whether the purchase price was artificially inflated. Thus, under the circumstances, Plaintiffs’ allegations of an economic loss are insufficient when considered in conjunction with the evidence of price recovery.}\]\(^{53}\)

*Malin* acknowledged that a price rebound does not, at the pleading stage, negate the plaintiff’s showing of economic loss.\(^{54}\) Judge Dorsey, however, substituted the phrase “current value” for the Supreme Court’s phrase “at that instant,” moving the relevant time forward more than 90 days to a post-disclosure market environment.\(^{55}\) In that environment, the disclosed fraud would be “priced into the stock” by the market.

The problem that the Second Circuit identified was that Judge Dorsey had conflated two events—a price decline and a later price rebound—and in so doing, effectively netted the economic results of two events of completely separate causal origin, comparable, in ef-

\(^{49}\) Id.
\(^{50}\) *Acticon*, 692 F.3d at 40.
\(^{51}\) Id.
\(^{52}\) Id. at 40-41 (quoting *Dura*, 544 U.S. at 342).
\(^{53}\) Id. at 41 (quoting *Malin*, 2005 WL 2146089, at *4). 
\(^{54}\) Id. at 39.
\(^{55}\) Cf. *Malin*, 2005 WL 2146089, at *4 (“If the current value is commensurate to the purchase prices, there is no loss, regardless of whether the purchase price was artificially inflated”) and *Dura*, 544 U.S. at 336.
fect, to an “offset defense.” A subsequent price recovery would, under such defense, always prove a prior price decline to have been temporary and, by virtue of a rebound, no loss could be causally attributed.

D. The Second Circuit’s “Functional Equivalence” Argument

The Second Circuit held that the district court’s analysis was “inconsistent with the traditional out-of-pocket measure which calculates economic loss based on the value of the security at the time the fraud becomes known,” as capped by the Reform Acts’ bounce-back provision, based on the mean-price, over the look-back period. The Second Circuit explained:

[A] share of stock that has regained its value after a period of decline is not functionally equivalent to an inflated share that has never lost value. This analysis takes two snapshots of the plaintiff’s economic situation and equates them without taking into account anything that happened in between; it assumes that if there are any intervening losses, they can be offset by intervening gains. But it is improper to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud if the stock recovers value for completely unrelated reasons.

The Second Circuit’s use of the term “value” focuses on Plaintiff’s ability to demonstrate economic loss without selling the affected security and, also, on the market value of the security preceding corrective disclosure. That “value” serves as a benchmark of economic loss sustained due to a subsequent market price decline. The Second Circuit stated it was unaware of any Supreme or Circuit Court decision imposing what it referred to as Malin’s “economic-loss rule” and found that the PSLRA, while imposing the 90-day bounce back cap

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56 Acticon, 692 F.3d at 41.
57 Id.
58 Id.
59 Id. (emphasis added).
60 Id.
on damages, did not impose the damage limitation rule Malin applied.\textsuperscript{61} The Second Circuit further explained that at the dismissal motion phase of litigation, showing a price recovery does not, in itself, “negate the inference” of economic loss for loss causation purposes.\textsuperscript{62} The court stated:

\[\text{At this stage in the litigation, we do not know whether the price rebounds represent the market’s reactions to the disclosure of the alleged fraud or whether they represent unrelated gains. We thus do not know whether it is proper to offset the price recovery against Acticon’s losses in determining Acticon’s economic loss. Accordingly, the recovery does not negate the inference that Acticon has suffered an economic loss. Accordingly, it would not be appropriate for a district court to consider whether a price rebound represented the market’s reaction to the disclosure of alleged fraud, or, as it might turn out, unrelated gains, which should not offset fraud-caused losses.}\textsuperscript{63}

\section{III. Dismissal Motion Practice—Loss Causation and the Second Investment Rule after Acticon}

The Second Circuit referred to the rule upon which the Acticon trial court relied as an “economic loss rule,” which held that if the price of a fraud-impacted security recovered subsequent to the corrective disclosure of a fraud to the extent that plaintiff would then be in a position to recover funds expended in buying the securities, he or she must act to recover out-of-pocket losses or minimize damages.\textsuperscript{64} However, if the investor fails to do so, a Rule 10b-5 claim seek-

\textsuperscript{61} Acticon, 692 F.3d at 41.
\textsuperscript{62} Id.
\textsuperscript{63} Id. See generally Laurence A. Steckman & Robert E. Conner, Litigating Offset Arguments in Compensatory Damage Litigation and Lead Plaintiff Motion Practice in Class Cases: Are Apparently Inconsistent Outcomes Reconcilable?, 3 J. Sec. L. Reg. & Comp. 150 (No. 2, Apr., 2010) (discussing case law on offset defenses in securities litigation and arbitration).
\textsuperscript{64} The phrase “economic loss rule” is frequently, although not exclusively, associated with tort/negligence cases. See, e.g., Hydro Investors, Inc. v. Trafalgar Power Inc., 227 F.3d 8, 16-17 (2d Cir. 2000) (“[e]conomic loss rule” is not always applied in negligence cases. Primarily, its continuing role is based on the recognition that “[r]elying solely on foreseeability to define the extent of liability [in cases involving economic loss], while generally effective,
ing damages was, prior to the Second Circuit decision in *Acticon*, subject to Rule 12 dismissal for failure to properly plead recoverable damages.\(^6^5\) The Second Circuit’s rejection of the Economic Loss Rule that the district court had applied in *Acticon* reflects a clarification of doctrines central to modern securities litigation, i.e., loss causation and the second investment rule, which, on policy grounds, place policy-based limits on plaintiff’s recoverable damages.

A. Dismissal Motion Practice and the Loss Causation Doctrine

Under current law, securities plaintiffs are required to plead claims, which, prior to discovery, are both plausible and compelling.\(^6^6\) This means the fraudulent explanation plaintiff proffers for challenged conduct in its initial pleading must be at least as likely as the non-fraudulent explanation defendant may proffer, in its Rule 12 motion, if dismissal is to be avoided.\(^6^7\) If plaintiff’s explanation satisfies this test, the pleading will survive and discovery, stayed automatically under the Reform Act upon defendant’s Rule 12 filing,\(^6^8\) will

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\(^{66}\) See *Sinay v. CNOOC Ltd.*, 554 F. App’x 40, 42 (2d Cir. 2014) (“[I]nference of scienter must be such that ‘a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw.’”) (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 323 (2007)).

\(^{67}\) See *Livingston v. Cablevision Systems Corp.*, No. 12-CV-377, 2013 WL 4763430, at *10 (E.D.N.Y. Sept. 5, 2013) (plaintiff alleging fraud in a § 10(b) action must plead facts rendering an inference of scienter at least as likely as any plausible opposing inference and must demonstrate it is more likely than not that the defendant acted with scienter—“An inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant’s conduct. . . . [A]n inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.”) (quoting *Tellabs*, 551 U.S. at 314).

commence.

Under the Reform Act, securities fraud plaintiffs are required to plead "loss causation," which requires that plaintiff plead facts plausibly showing defendant proximately, that is, foreseeably and/or directly, caused the damages for which recovery is sought. When plaintiff’s loss results from the materialization of a non-market risk that was not (or was not properly) disclosed to the injured party, loss causation is shown because the loss is deemed causally traceable (and sufficiently direct and/or foreseeable) to disclosure misconduct. The policy behind loss causation is the same as that which underlies the concept of tort law proximate causation, namely avoidance of recovery of potentially unlimited damage claims that would contravene public policy and turn errant defendants into windfall guarantors. It does so by precluding recovery when injury was neither foreseeable nor a direct (causal) result of the challenged conduct.

The question is whether the policies underlying the loss causation doctrine are vindicated or undermined by the Second Circuit’s ruling in Acticon.

Under the Second Circuit’s theory in Acticon, the fact that plaintiff loses $10 per share out-of-pocket and can recover 100% of its out-of-pocket loss through subsequent re-appreciation of the market price of the security does not mean plaintiff lacks recoverable damages. This is because shareholders have a right to benefit from the bargain they struck, namely price appreciation, inherent in their payment of a purchase price for a security investment, from all appropriate sources. In contrast, a theory of damages that implicitly or explicitly “nets” or “offsets” gains from exogenous non-fraud-related events against fraud-caused losses would effectively adopt an

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69 See 15 U.S.C. § 78u-4(b)(4) (“[T]he 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.”).
70 See Dura, 544 U.S. at 342.
72 Id. at nn.3-41.
73 Id.
approach to causation and damages that courts have repeatedly rejected.\textsuperscript{75}

Such netting/offsetting defenses have been rejected on several grounds, including the fact that allowing defendants to offset or net gains against fraud-caused losses would provide them with an inappropriate windfall, to the detriment of the injured party.\textsuperscript{76} The “functional equivalence” language in \textit{Acticon} does little to explain why the “economic loss rule” was properly rejected. The real reason is that the netting implicit in the district court’s economic loss rule would prevent an apples-to-apples comparison as to the reasons for the loss being claimed. Losses due to fraud stand on a different footing from gains due to non-fraud-related causes and netting/offset defenses have been rejected in securities cases.\textsuperscript{77} Although the district court correctly observed that a plaintiff who forgoes a chance to sell at a profit following a corrective disclosure cannot logically ascribe a later loss to devaluation caused by the disclosure, what constitutes “profit” cannot be separated from economic and legal conditions that generate it. A rule that permits defendants to benefit from a post-disclosure stock price increase to offset fraud-caused losses not only shields defendants from potential liability for their securities misconduct but might deprive an investor of damages to which equity might suggest he or she should be entitled, based on the benefit for which he or she had bargained, in the first instance.

\textbf{B. Second Investment Rule and Unrelated Gains}

The Second Circuit explained that if it were to offset “unrelated gains” against plaintiff’s recovery for the inflated purchase price, plaintiff would not be brought to the same position as a plaintiff who was not defrauded.\textsuperscript{78} Quoting \textit{Harris v. American Investment Co.},\textsuperscript{79} a leading second investment rule case, the Second Circuit explained this was because the defrauded plaintiff would lack the “opportunity to profit (or suffer losses) from ‘a second investment decision unrelated to his initial decision to purchase the stock.’”\textsuperscript{80}

\begin{flushleft}
\textsuperscript{75} See generally Steckman, \textit{Litigating Offset Arguments in Compensatory Damage Litigation}, supra note 63. \\
\textsuperscript{76} Id. (collecting and discussing cases). \\
\textsuperscript{77} Id. \\
\textsuperscript{78} \textit{Acticon}, 692 F.3d at 41. \\
\textsuperscript{79} 523 F.2d 220 (8th Cir. 1975). \\
\textsuperscript{80} \textit{Acticon}, 692 F.3d at 41 (quoting \textit{Harris}, 523 F.2d at 228).
\end{flushleft}
The *Harris* court explained the rationale for the second investment rule—if an investor, aware fraud occurred, nonetheless chooses to continue to hold the affected security, he or she has made a second investment decision “unrelated” to the initial purchase decision.\(^\text{81}\) Such a second investment decision, by virtue of being made after corrective disclosure of the fraud, would not be affected by the fraud. Any loss incurred as a result of a second investment decision will be due to a materialization of (post-fraud) market risk and is not the result of the alleged fraudulent conduct of a defendant.\(^\text{82}\) In a market unaffected by fraud, the price at which a security trades is thought, under the efficient market hypothesis, to reflect all available market information.\(^\text{83}\) The second investment rule is designed to al-

\(^{81}\) *Harris*, 523 F.2d at 227-28 (where plaintiff purchased shares at a time when, he alleged, the filing of false and misleading information had artificially inflated the market price, district court found plaintiff suffered no damages because he could have recovered his investment by selling just after he had made his investment or after filing his lawsuit—the appeal court reversed, holding plaintiff could show damages by proving the actual value of securities on the purchase date was less then what plaintiff paid for them or by comparing the latter sum with the market value of the securities after fraud was publicly disclosed). *Accord* Shapiro v. Midwest Rubber Reclaiming Co., 626 F.2d 63, 68-69 (8th Cir. 1980) (damages for securities fraud are determined in accordance with the extent to which false and misleading information actually harmed the complaining party, either directly (through actual reliance) or indirectly (by affecting the market upon which the party traded)).

\(^{82}\) *Harris*, 523 F.2d 228 (a defrauded buyer can maintain a damages action, even if he continues to hold securities because, in such a case, the buyer has: “in effect, made a second investment decision [at the time he discovers the fraud, one] unrelated to his initial decision to purchase the stock.” Damages for fraud in the initial transaction are not affected by events after this second decision.); *see* Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., 888 F. Supp. 2d 431, 475 n.294 (S.D.N.Y. 2012), quoting *In re* Oxford Health Plans, Inc. Sec. Litig., 244 F. Supp. 2d 247, 250 (S.D.N.Y. 2003). The court stated:

The damages of a purchaser were always understood to be the difference between the purchase price and the true value of the shares (adjusted for any negative causation) as disclosed after the revelation of the fraud to the public, followed by a reasonable period (usually no longer than a week or ten days) during which the market took cognizance of the fraud and the publicly traded price was presumed, under the ‘efficient market’ hypothesis endorsed by the Supreme Court in *Basic* [Inc. v. Levinson, 485 U.S. 224 (1988)], to reflect an adjustment for the fraud. If the plaintiff or absent class member retained the security after the period of time within which the efficient market adjusted for the revelation of the fraud, he or she made a new investment decision, and could not collect damages for any further drop in the market price.

\(^{83}\) The efficient market hypothesis states that stock market efficiency will cause existing share prices to always incorporate and reflect all relevant information and, for that reason, equities will always trade at fair value on stock exchanges. The theory is controversial and commentators have questioned its use in securities cases. *See, e.g.*, Laurence A. Steckman,
low plaintiff to recover only that amount by which he or she was injured due to the price-distorting effects of fraudulent representation(s), preventing windfalls unrelated to defendant’s misconduct. From the perspective of damage mitigation, when plaintiff knows a fraud occurred, but fails to act to minimize damages within a reasonable period of time after learning of it, he or she is disabled from

Risk Arbitrage and Insider Trading: A Functional Analysis of the Fiduciary Concept under Rule 10b-5, 5 Touro L. Rev. 121, 142-53 (1988) (discussing fraud on the market theory and presumption of reliance under then recent authority, Basic v. Levinson, 485 U.S. 224 (1988), advocating alternative market impact theory of insider trading liability under functional analysis). In 2013, in Amgen Inc. v. Connecticut Retirement Plans & Trust Funds, 133 S. Ct. 1184 (2013), four Supreme Court Justices questioned both the fraud on the market theory and the efficient market hypothesis upon which it is based. Justice Ginsburg noted current economic research showing market efficiency is not a “binary, yes or no question,” concluding that “differences in efficiency can exist within a single market.” Id. at 1198 n.6. Justice Scalia called Basic “arguably regrettable” authority. Id. at 1206 (Scalia, J., dissenting). Justice Thomas called the theory “questionable.” Id. at 1208 n.4 (Thomas, J., dissenting). Justice Alito stated that a reconsideration of the Basic reliance presumption might overrule the theory entirely. Id. at 1204 (Alito, J., dissenting).

See Katz v. First of Michigan, No. K87-264 CA4, 1989 WL 62196, at *12-13 (W.D. Mich. Mar. 13, 1989) (where plaintiff continues to hold the stock after discovery of the fraud, he can be deemed to have made a second investment decision and “his recovery will be correspondingly reduced. . . . [D]amages are limited by what the plaintiffs would have realized if they had acted upon their claim when they first learned of the fraud or had reason to know of it.”) (citations omitted).

See In re Olympia Brewing Co. Sec. Litig., No. 77 C 1206, 1985 WL 3928, at *8-9 (N.D. Ill. Nov. 13, 1985) (“The law does not permit an investor to stay and see how things work out after discovering the alleged past impropriety which brought him to the decision to stay or get out, and then recover damages for events which follow the investor's decision to stay,” (citing Harris, 523 F.2d at 228)). The court explained:

Although a plaintiff need not sell his stock after discovery of the fraud in order to bring his cause of action, he cannot recover for the diminution in value of the stock following the discovery because he has, in effect, made a second investment decision to purchase the stock. Plaintiffs who are found to have made a second investment decision cannot recover for any losses which result from that decision, not because they are equitably estopped from doing so, but because those losses were not caused by their initial decision to purchase.

Id.

Time is “reasonable” when it allows the owner to consult counsel and to employ another broker and/or analyze the market. See generally Nye v. Blyth Eastman Dillon & Co., Inc., 588 F.2d 1189 (8th Cir. 1978) (under second investment doctrine, once a reasonable time passes, any increase or decrease in stock value cannot be causally tied to the fraud that caused the initial purchase decision and later events, for this reason, will not affect damage calculations); Cant v. A. G. Becker & Co., Inc., 379 F. Supp. 972, 975 (N.D. Ill. 1974) (where defendant argued damages plaintiff suffered based on diminished value of stock should be offset by value of shares held after complaint was filed, the “key date as to the damage issue” under the second investment rule was the date plaintiff discovered or should have discovered he was defrauded.). The court stated:
recovering damages. The idea behind the second investment rule is that plaintiff’s “second investment decision” has broken the causal link between defendant’s conduct and the plaintiff’s damage. The idea behind damage mitigation rules is that by requiring a plaintiff to act to reduce its damages in an instance in which doing so is reasonably achievable, economic efficiencies are preserved for the benefit of the economic system, as a whole. Mitigation is generally raised as an affirmative defense in a responsive pleading, is fact intensive and, for this reason, not generally the subject of Rule 12 motion practice.

IV. CONCLUSION

After Acticon, defense counsel may still properly argue, in appropriate cases, that plaintiff has failed to plead a sufficient causal link between fraudulent conduct and directly or foreseeably caused loss and that dismissal of the pleading is required. However, they may not do so by relying sub silentio on an economic loss rule that itself relies on an offsetting/netting strategy with built-in factual assumptions that cannot be established under Rule 12 motion rules. This is especially appropriate in cases where “netting” or “offsetting” contravenes fundamental intuitions of fairness and/or applicable benefit of the bargain principles.

The plaintiff will not be able to avail himself of any further decrease in the value of the security after that date. So also the defendant should not be able to avail itself of any increase in the value of the stock after that date. This is the only method in which a consistent measure of damages can be obtained. If the defendant’s contention was accepted the scale of damages would be prejudicially tipped in favor of the defendant.

Id. See generally Marbury Mgmt., Inc. v. Kohn, 470 F. Supp. 509, 516, n.13 (S.D.N.Y. 1979), rev’d in part on other grounds, 629 F.2d 705 (1980) (plaintiffs’ gross economic losses must be reduced by the amount plaintiffs lost due to their failure to sell securities within a reasonable period after discovering defendant’s fraud, noting the Second Circuit “seems to regard plaintiff’s failure to mitigate damages as a possible ground for reducing the amount of the damage award in an appropriate case,” and that such an approach has received support from courts and commentators alike because it attempts to calculate the amount of damages based upon losses attributable to the fraud, citing, inter alia, Harris, and stating: “if the plaintiff continues to hold the stock after the discovery of the fraud, he can be deemed to have made a ‘second investment decision,’ based on the ‘total mix’ of information available.”).

88 See generally Laurence A. Steckman & Robert E. Conner, Computing Damages in Rule 10b-5 Unsuitability Cases: Litigating “Offset” Defenses, in 1994 SEC. ARBITRATION, Ch. 24 at 377-431 (P.L.I. 1994) (discussing market index adjusted damages as a species of benefit of the bargain recovery); see supra note 63.