Securities Law—Second Circuit Accepts Rule 10b-5 Pleading of Economic Loss After Share-Price Recovery—*Acticon AG v. China North East Petroleum Holdings Ltd.*, 692 F.3d 34 (2d Cir. 2012)

Securities and Exchange Commission (SEC) Rule 10b-5[1] provides the principal remedy for private investors ensnared in fraudulent securities transactions.[2] A successful pleading of a fraud-on-the-market claim under Rule 10b-5 requires a showing of actual economic loss caused by a fraudulently inflated price of a security purchased by the plaintiff.[3] In *Acticon AG v. China North East Petroleum Holdings Ltd.*,[4] the Court of Appeals for the Second Circuit considered whether a defrauded investor's unrealized opportunity to sell securities at a profit precludes the ability to prove economic loss under Rule 10b-5's fraud-on-the-market theory.[5] The Second Circuit held that a recovery in share price after the fraud was disclosed to the purchasers does not automatically defeat an inference of economic loss at the pleading stage.[6]

Between January and May of 2010, Acticon AG (Acticon) acquired a total of 60,000 shares in China North East Petroleum Holdings Limited (NEP) at an average price of $7.25 per share.[7] Acticon alleged in its complaint that after

1. 17 C.F.R. § 240.10b-5 (2013).

2. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008) ("Though the text of the Securities Exchange Act does not provide for a private cause of action for § 10(b) violations, the Court has found a right of action implied in the words of the statute and its implementing regulation."); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) (establishing private right of action under section 10(b) of Securities Exchange Act of 1934); *see also* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.3[1], at 441 (6th ed. 2009) (describing evolution of implied remedy under Rule 10b-5).

3. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 347 (2005) (requiring claim that price fell in Rule 10b-5 complaint for fraudulently inflated purchase price). Under the fraud-on-the-market doctrine, the element of reliance is presumed and subject to rebuttal when materially misleading statements involving securities traded in an efficient market are publicly disseminated. *See* Basic Inc. v. Levinson, 485 U.S. 224, 246-47 (1988) (approving fraud-on-the-market doctrine in cases of affirmative misrepresentations). The Supreme Court has consistently identified six elements that must be proven to prevail on a Rule 10b-5 claim: a material misrepresentation or omission by the defendant; intent to defraud; a connection between the misrepresentation or omission and the purchase or sale of a security; reliance upon the misrepresentation or omission; economic loss; and loss causation. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008) (limiting Rule 10b-5 liability to conduct that satisfies each element).

4. 692 F.3d 34 (2d Cir. 2012).

5. *Id.* at 35-36. Although it was a matter of first impression in the Second Circuit, a number of district courts throughout the country had addressed the issue. *See id.* at 39 (disagreeing with cases decided by district courts in three separate circuits).

6. *See id.* at 41-42 (remanding case to district court for further proceedings).

7. *In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 353 (S.D.N.Y. 2011), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012). Acticon paid a total of $434,950 for its 60,000 NEP shares through eleven purchases: 2500 shares at $9.60 per share on January 20, 2010; 2500 shares at $9.30 per share on January 21, 2010; 2500 shares at $8.35 per share

each acquisition of stock, NEP disclosed corrections to financial statements that the company had filed with the SEC prior to Acticon's purchases.[8] NEP issued its first allegedly corrective disclosure on February 23, 2010, when the company announced it was withdrawing its 2008 and 2009 financial statements due to purported accounting errors.[9] According to the complaint, NEP made its final corrective disclosure on September 1, 2010, when it filed restated financial reports that eliminated its entire originally reported profit margin.[10] Although Acticon held its NEP stock for several months after NEP's final disclosure, the company ultimately sold a portion of its 60,000 NEP shares by May 2011 at prices ranging from $3.50 to $6.33 per share.[11] However, on twelve separate occasions during the period between NEP's final corrective disclosure and Acticon's sale of NEP stock, NEP stock traded and closed higher than Acticon's purchase price of $7.25 per share.[12]

Acticon filed suit against NEP in the United State District for the Court Southern District of New York, alleging securities fraud under Section 10(b) of

on January 26, 2010; 2500 shares at $8.51 per share, 2500 shares at $8.31 per share, and 5000 shares at $8.26 per share on April 19, 2010; 2500 shares at $6.99 per share on May 6, 2010; 20,000 shares at $6.75 per share, 10,000 shares at $6.65 per share, and 1000 shares at $6.45 per share on May 14, 2010; and lastly, 9000 shares at $6.45 per share on May 17, 2010. *Id.*

8. *See* 692 F.3d at 36 (observing price of NEP shares "fell sharply" after each disclosure); *see also In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 353 (S.D.N.Y. 2011) (noting final alleged corrective disclosure occurred September 1, 2010), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012).

9. *See* 692 F.3d at 36 (summarizing NEP's gradual disclosure of information to public). NEP's board of directors explained that its reported financial statements could no longer be relied upon because they contained various "non-cash" accounting errors. *See* China N.E. Petrol. Holdings Ltd., Current Report (Form 8-K) (Feb. 23, 2010) (responding to comments from SEC's review of NEP's 2008 and 2009 financial statements). The president of NEP announced that its financial corrections resulted in an increase in the company's 2008 adjusted net income and a decrease in its 2009 adjusted net income. *See China North East Petroleum Clarifies Non-Cash Accounting Adjustments to Previously Issued 2008 and 2009 Financial Statements,* PR NEWSWIRE (Mar. 8, 2010), http://www.prnewswire.com/news-releases/china-north-east-petroleum-clarifies-non-cash-accounting-adjustments-to-previously-issued-2008-and-2009-financial-statements-86944972.html (reporting NEP's announcement of impact of revised financial statements).

10. *See In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 353 n.2 (S.D.N.Y. 2011) (declining to elaborate on alleged disclosure), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012); Brief and Special Appendix for Plaintiff-Appellant at 13, Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012) (No. 11-4544-cv), 2011 WL 7111554, at *13. NEP stock resumed trading on September 9, 2010, and its share price plummeted by nearly twenty percent. *See* 692 F.3d at 36 (noting sharp price decline took place on "very high volume" of trading of NEP stock).

11. *See In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 353 (S.D.N.Y. 2011), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012). The aggregate result of Acticon's purchase and sale of NEP shares was a loss of $215,149—forty-nine percent of its initial investment. *See* Brief and Special Appendix for Plaintiff-Appellant, *supra* note 10, at 14.

12. *In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 353 (S.D.N.Y. 2011) (describing twelve days as forgone opportunities for Acticon to profitably sell its holdings), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012). All twelve days that NEP's stock price closed higher than $7.25 were between October and November 2011. *Id.*

the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5.[13] In the complaint, Acticon claimed NEP misled investors as to its financial viability and anticipated profits, and caused Acticon significant economic losses by repeatedly issuing corrective disclosures that prompted declines in NEP's share price.[14] On March 22, 2011, NEP filed a motion to dismiss for failure to state a claim, asserting that Acticon repeatedly passed on opportunities to realize a profit and therefore suffered no loss.[15] The district court sided with NEP, dismissing the case on the grounds that Acticon's prolonged holding and subsequent sale of NEP stock at a loss, combined with several foregone opportunities to sell the shares at a profit, resulted in a failure to show the requisite economic-loss element of securities fraud.[16]

The Great Depression and the decade that preceded it—a period of unprecedented growth in securities speculation, issuance, underwriting and investment in the United States—provided the impetus for the federal legislation that is the basis of today's securities laws.[17] The Securities Act of

13. *In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 352 (S.D.N.Y. 2011) (granting defendants' motions to dismiss under Rule 12(b)(6) of Federal Rules of Civil Procedure), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012). Both the district court and the Second Circuit analyzed Acticon's securities-fraud claim under a fraud-on-the-market theory. *See* 692 F.3d at 40 (describing multitude of market forces with potential to affect share price); *In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 352 (S.D.N.Y. 2011), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012).

14. *See* 692 F.3d at 36 ("Acticon alleges that NEP inflated its proven oil reserves and did not account for certain warrants—which entitle the holder to purchase stock for a fixed price until the expiry date—in accordance with Generally Accepted Accounting Principles . . . ."). Acticon also alleged that NEP misled investors about reported earnings and internal controls, and that the former CEO and his mother pilfered corporate coffers. *See id.* (summarizing Acticon's allegations). The complaint sought class certification, but the district court granted NEP's motion to dismiss before considering the class-certification issue. *See In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 352 & n.1 (S.D.N.Y. 2011) (dismissing Acticon's "putative class action complaint"), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012).

15. *See* 692 F.3d at 37 (providing procedural history of appeal); *In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 352 (S.D.N.Y. 2011) (granting three motions to dismiss filed by defendants), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012).

16. *See In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 353 (S.D.N.Y. 2011) (declining to hold NEP responsible for Acticon's loss), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012). In dismissing Acticon's claim, the court grounded its reasoning in a line of district court cases applying a 2005 Supreme Court decision interpreting the pleading requirements of a Rule 10b-5 claim. *See id.* at 352-53 ("[T]he Supreme Court[] reject[ed] . . . an artificially inflated purchase price alone as an economic loss. If the current value is commensurate to the purchase prices, there is no loss, regardless of whether the purchase price was artificially inflated." (quoting Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089, at *4 (D. Conn. Sept. 1, 2005))); *see also* Ross v. Walton, 668 F. Supp. 2d 32, 43 (D.D.C. 2009) (holding economic loss not demonstrated if stock value surpasses purchase price); *In re* Veeco Instruments, Inc. Sec. Litig., No. 05-MD-01695 (CM)(GAY), 2007 WL 7630569, at *7 (S.D.N.Y. June 28, 2007) (holding plaintiffs could not prove economic loss).

17. *See* EDWARD T. MCCORMICK, UNDERSTANDING THE SECURITIES ACT AND THE S.E.C. 18-21 (1948) (explaining historical influences leading to federal securities legislation). The economic prosperity of the 1920s resulted in a rise in valuable securities. *See id.* at 18. Successful businesses, observing the increase in prices of securities, began issuing a greater number of securities. *See id.* The unsustainable boom led millions

1933 ('33 Act) requires extensive financial disclosures prior to issuing stock for sale to the public, while the Exchange Act mandates continual periodic disclosures by publicly traded securities issuers after their initial public tender offer.[18] In 1942, after a brief deliberation, the SEC promulgated Rule 10b-5, which would unintentionally become the chief remedy for defrauded investors of private securities.[19] Because Rule 10b-5's private right of action arose from judicial construction, the development and refinement of its elements has taken considerable time and generated voluminous litigation.[20] By the early 1970s, the increasing role of Rule 10b-5 in abusive, meritless complaints prompted the United States Supreme Court to take action in a slew of decisions that dramatically curtailed the ability of private parties to sue under Rule 10b-5.[21]

of Americans to invest heavily in the stock market, and by August 1929 loans from brokers accounted for two-thirds of the face value of the stocks that small investors were buying. *See* Richard Lambert, *Crashes, Bangs & Wallops*, FIN. TIMES, July 19, 2008, http://www.ft.com/cms/s/0/7173bb6a-552a-11dd-ae9c-000077b07658.html (summarizing causes of 1929 stock-market crash). With the vast influx of capital to securities markets, issuers were suspected of purposefully issuing excessive amounts of securities, disclosing minimal information to the public, and fabricating or failing to support the information they disclosed. *See* MCCORMICK, *supra*, at 20 (noting many deserved blame in addition to issuers).

18. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-95 (1976) (identifying protection of investors as Congress's goal in enacting both acts). As part of the '33 Act, Congress created the SEC, which they entrusted with an "arsenal of flexible enforcement powers." *Id.* at 195 (citing Securities Act of 1933 §§ 8, 19, 20, 15 U.S.C. §§ 77h, 77s, 77t (2012); Securities Exchange Act of 1934 §§ 9, 19, 21, 15 U.S.C. §§ 78i, 78s, 78u (2012)). Most significantly, section 10(b) of the Exchange Act conferred upon the SEC the power to prescribe rules and regulations "necessary or appropriate in the public interest or for the protection of investors." Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(a)(1) (2012); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201, 212 (1976) (rejecting negligence and requiring scienter in Rule 10b-5 actions).

19. *See* Milton V. Freeman, *Foreword*, 61 FORDHAM L. REV. S1, S1-S2 (1993). The SEC was informed that a president of a corporation misled shareholders into thinking the company was doing poorly in order to purchase their holdings at depressed prices, and in response, the SEC drafted and approved Rule 10b-5 that same day. *Id.* at S1. Milton V. Freeman, the Assistant Solicitor of the SEC from 1934 through 1946 and co-drafter of Rule 10b-5, recounted the rule's adoption: "We passed a piece of paper around . . . . All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, 'Well,' he said, "we are against fraud, aren't we?'" Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967).

20. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."); James D. Gordon III, *Acorns and Oaks: Implied Rights of Action Under the Securities Acts*, 10 STAN. J.L. BUS. & FIN. 62, 93-95 (2004) (listing aspects of Rule 10b-5 actions decided by Supreme Court over fifty years). In 1946, a district court interpreted Rule 10b-5 as creating a private remedy for investors. *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946) (finding tort liability for violating statute without private enforcement provision). The implied remedy quickly gained prominence in the federal judiciary, but the Supreme Court did not recognize it until 1971. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) (confirming petitioner's standing to sue for fraud in connection with sale of bonds).

21. *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479-80 (1977) (denying liability for corporate mismanagement and unfair treatment by fiduciary without manipulative or deceptive transaction); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201, 212 (1976) (requiring scienter in order to establish defendant's liability in Rule 10b-5 suit); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737-38 (1975) (limiting standing to sue under Rule 10b-5 to purchasers and sellers of securities); Sierra Club v. Morton, 405 U.S. 727, 731-41 (1972) (denying standing to plaintiff for failing to assert individualized harm); *see also* HAZEN, *supra* note 2, § 12.3[3], at 443 (summarizing judicially-developed requirements in Rule 10b-5 suits). The Court recognized the

In 1988, however, the Court decided *Basic Inc. v. Levinson*,[22] signaling a significant departure from previous limitations on Rule 10b-5 liability by adopting a presumption of reliance under the fraud-on-the-market theory.[23]

After *Basic*, the sheer volume of Rule 10b-5 litigation and the damages alleged per lawsuit increased dramatically.[24] In the decade following *Basic*, the abundance of securities-fraud class actions engendered more scholarly and judicial criticism of Rule 10b-5's implied private remedy than ever before.[25] In 1995, Congress stepped in and passed the Private Securities Litigation Reform Act (PSLRA)—the first legislatively imposed limits on Rule 10b-5's judicially-created cause of action.[26] Among its many reforms, the PSLRA raised the

hazard of strike suits—meritless lawsuits filed to induce corporations to settle and avoid the costly expense of litigation—facilitated by particular aspects of Rule 10b-5 litigation: the ease with which a plaintiff can allege the requirements for standing and the potential for abuse of liberal discovery rules, which may exist in this type of case to a greater extent than in other litigation. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975) (describing Rule 10b-5 as social cost when used to bring strike suits).

22. 485 U.S. 224 (1988).

23. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988) ("Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action."). Under the fraud-on-the-market theory, a plaintiff could file a 10b-5 suit based on misstatements or omissions in public disclosure documents and satisfy pleading requirements without ever alleging that they read those documents. *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1311 (2008). Well before it adopted the fraud-on-the-market theory, the Supreme Court recognized the unprecedented characteristics of transactions in modern-day securities markets, and the difficulty in applying Rule 10b-5's traditional tort elements. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-45 (1975) ("[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable.").

24. *See* Rose, *supra* note 23, at 1311-12 (crediting 1966 amendments to Rule 23 of Federal Rules of Civil Procedure for establishing "modern class action device"). By moving an issue of substantial variation among the plaintiffs to a later stage in the proceeding and burdening the defendant with rebutting it, the fraud-on-the-market presumption of reliance invites class certification. *See* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 892 (1992). The filing rate of class-action securities fraud suits "nearly tripled between April 1988, just after *Basic* was decided, and June 1991." Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 663 (1992). The typical Rule 10b-5 suit became a class action on behalf of thousands of uninformed investors against a corporate defendant with substantial financial resources that provided the potential for tens or hundreds of millions of dollars in recoverable damages. *See* Rose, *supra* note 23, at 1312 & n.42 (explaining consequences of fraud-on-the-market presumption).

25. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 188-90 (1994) (denying Rule 10b-5 liability for aiding and abetting). In *Central Bank*, the Court echoed its pronouncements from *Blue Chip Stamps* in which it bemoaned the "danger of vexatiousness" that Rule 10b-5 presents and that it "requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." *Id.* at 189; *see* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975). The dominant criticism of class actions under Rule 10b-5 has been the misalignment of interests between the class and its counsel; the propriety of the Rule's private enforcement, however, has consistently been accepted. *See* Rose, *supra* note 23, at 1316-19 (crediting work of Professor John C. Coffee for sustaining agency-cost critique).

26. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.). Faulting the implied action's judicial origins, Congress passed the PSLRA as a response to the same concerns that the Supreme Court had raised in its decisions limiting the scope of Rule 10b-5 liability. *See* S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995

pleading standards for Rule 10b-5 claims by requiring plaintiffs to demonstrate and prove loss causation.[27] Over several years following PSLRA's enactment, the circuits eventually developed two conflicting applications of the statutory requirements of well-pleaded loss causation.[28] In 2005, the Supreme Court addressed the circuit split head-on in *Dura Pharmaceuticals, Inc. v. Broudo*,[29] when the Court unanimously held that an allegation of an inflated purchase price does not alone constitute a sufficient pleading of loss causation in a fraud-on-the-market complaint.[30]

U.S.C.C.A.N. 679, 683 ("The lack of congressional involvement has left judges free to develop conflicting legal standards, thereby creating substantial uncertainties and opportunities for abuses of investors, issuers, professional firms and others.").

27. *See* 15 U.S.C. § 78u-4(b) (2012). The legislative history of the PSLRA reveals the influence that case law from the Second Circuit had on the new pleading requirements. *See* H.R. REP. NO. 104-369, at 41 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 740 (deriving new pleading standard from Second Circuit's requirement). The loss causation element was codified in the Exchange Act as follows: "[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." 15 U.S.C. § 78u-4(b)(4). Scholars credit a 1974 Second Circuit opinion as the seminal decision in the separation of loss causation as an independent element from transaction causation, a distinction ultimately codified in the PSLRA. *See* Ann Morales Olazábal, *Loss Causation in Fraud-on-the-Market Cases Post*-Dura Pharmaceuticals, 3 BERKELEY BUS. L.J. 337, 343-48 (2006) (citing Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974)). In that case, the Second Circuit described Rule 10b-5's causation requirement as including "loss causation—that the misrepresentations or omissions caused the economic harm—and transaction causation—that the violations in question caused the [plaintiff] to engage in the transaction in question." Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974).

28. *Compare* Emergant Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc., 343 F.3d 189, 198 (2d Cir. 2003) (holding plaintiff satisfied loss-causation pleading requirement because complaint linked price inflation to subsequent decline), Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) (holding additional allegations of price decline in response to disclosure of misrepresentations satisfied loss causation), *and* Robbins v. Kroger Props., Inc., 116 F.3d 1441, 1448 (11th Cir. 1997) (rejecting inflated purchase price alone as sufficient allegation of loss causation), *with* Gebhardt v. ConAgra Foods, Inc. 335 F.3d 824, 832 (8th Cir. 2003) ("[P]laintiffs were harmed when they paid more for the stock than it was worth. This [alone] is a sufficient allegation."), *and* Broudo v. Dura Pharm. Inc., 339 F.3d 933, 939 (9th Cir. 2003) ("[L]oss causation does not require pleading a stock price drop following a corrective disclosure or otherwise."), *rev'd*, 544 U.S. 336 (2005). Circuits following the price inflation approach—the Eighth and Ninth—focused on the moment a plaintiff purchased the security and required a showing that the purchase price was artificially inflated due to the defendant's misconduct. *See* Matthew L. Fry, *Pleading and Proving Loss Causation in Fraud-on-the-Market-Based Securities Suits Post*-Dura Pharmaceuticals, 36 SEC. REG. L.J. 31, 38-39 (2008). Conversely, the Second, Third, and Eleventh Circuits required 10b-5 plaintiffs to not only plead a fraudulently inflated price, but also that they suffered a loss by overpaying, which was typically satisfied by alleging a corrective price decline after revelation of the fraud. *See id.* at 37-38.

29. 544 U.S. 336 (2005).

30. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 347-48 (2005) (conceding ordinary pleading rules should not impose great burdens on plaintiffs). The Court reasoned that an investor could not suffer a loss by merely paying an inflated price for a security because any inflation in the price at the moment of purchase is offset by the investor's ownership of a share of equivalent value. *See id.* at 342 (requiring proximate causation between misrepresentation and price decline). Additionally, the Court noted that a subsequent drop in stock price may result from changed economic circumstances, which investors assume as an inherent risk of owning the security rather than the result of fraudulent misrepresentation. *See id.* at 342-43 (focusing on whether truth of misrepresentation penetrated market). The Court concluded that affirming the price inflation approach would effectively transform Rule 10b-5 into an investment insurance policy, allow abusive strike suits, and

In *Dura,* the Court put to rest the issue of inflated purchase prices serving as a basis of private actions for securities fraud, but the Court's narrow holding led to confusion in the lower courts over the circumstances that may constitute a showing of actual economic loss under the PSLRA.[31] Indeed, the lower courts have cited *Dura* and its reasoning in widely divergent situations, including those in which a complainant failed to avoid significant financial loss by retaining its holdings in a company when an opportunity to sell the securities for a profit arose after the fraud on the market had been publicly disclosed.[32] These courts have equated their treatment of post-disclosure recoveries in share price with the Supreme Court's rejection of fraudulently inflated purchase prices as a complaint's sole allegation of economic loss.[33] Since the PSLRA embedded the element of loss causation in Rule 10b-5 claims, the Supreme Court's decision in *Dura* has served as the only interpretive precedent of the statute, leading to several district court rulings concluding that evidence of post-fraud-disclosure recovery in share price renders any allegation of economic loss insufficient in fraud-on-the-market suits under Rule 10b-5.[34]

In *Acticon AG v. China North East Petroleum Holdings Ltd.,* the Second

contradict the congressional intent of the securities statutes. *See id.* at 347-48 (holding plaintiffs' pleadings should indicate some loss and causal connection to defendants).

31. *See* Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 350-51 (2007) (describing *Dura* as missed opportunity in which Court "muddied the water with regard to what constituted loss"); Olazábal, *supra* note 27, at 379 ("*Dura* may be just as important for what it did not accomplish as for what little it said about loss causation."). The Court's narrow holding requires 10b-5 plaintiffs in fraud-on-the-market suits to plead an "actual economic loss" (a term appearing throughout the opinion), but never specifies what type of allegations would satisfy the requirement. *See* Merritt B. Fox, *After* Dura: *Causation in Fraud-on-the-Market Actions*, 31 J. CORP. L. 829, 846-47 (2006) (arguing Supreme Court failed to establish what satisfies pleading standards).

32. *See, e.g., In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351, 352 (S.D.N.Y. 2011) (borrowing reasoning and language from *Dura*), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012); *In re* Immucor, Inc. Sec. Litig., No. 1:09–CV–2351-TWT, 2011 WL 3844221, at *2 (N.D. Ga. Aug. 29, 2011) (ruling purchaser suffers no economic loss if stock rises above purchase price); Ross v. Walton, 668 F. Supp. 2d 32, 43 (D.D.C. 2009) (citing language in *Dura*); *In re* Veeco Instruments, Inc. Secs. Litig., No. 05-MD-01695 (CM)(GAY), 2007 WL 7630569, at *7 (S.D.N.Y. June 28, 2007) (following reasoning in *Dura* and requiring purchaser prove economic loss); Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089, at *4 (D. Conn. Sept. 1, 2005) (finding purchaser suffers no economic loss if stock rises above purchase price).

33. *See* 692 F.3d at 41-42 (reviewing analysis of several federal district court decisions); Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089, at *3-4 (D. Conn. Sept. 1, 2005) (extrapolating from opinion in *Dura* less than five months after Supreme Court issued it). These courts have understood the Supreme Court's logic in *Dura* 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," as the basis for their expansion of the Court's holding to cases of price recovery. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342 (2005); s*ee also* Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089, at *3 (D. Conn. Sept. 1, 2005) (finding evidence of price recovery renders allegations of economic loss insufficient).

34. *See* Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089, at *4 (D. Conn. Sept. 1, 2005) (serving as foundation for subsequent district court decisions holding similarly).

Circuit considered whether a Rule 10b-5 plaintiff that forgoes several post-disclosure opportunities to profit by selling its shares above the purchase price may allege legally sufficient economic loss.[35] The court framed its discussion of economic loss by reviewing the measure of damages applicable in Rule 10b-5 cases, which, according to the court, included both the judicially established out-of-pocket calculation method as well as the PSLRA's statutorily created limitations.[36] In *Acticon*, the court reasoned that neither the "bounce-back" provision in the PSLRA nor the Supreme Court's holding in *Dura* had altered the traditional out-of-pocket measure of damages and, as such, any pleading requirement based on damages—that is, economic loss—must also be consistent with the out-of-pocket framework.[37] In its declaration that the difference between a security's predisclosure "value" and its purchase price is recoverable under Rule 10b-5, the Second Circuit discussed the unique qualities of stock ownership and the inherently inequitable consequences of disallowing the entire class of Rule 10b-5 claims that involve post-disclosure recoveries in share price.[38] The appellate panel also characterized the district

35. *See* 692 F.3d at 36 (addressing issue of first impression for court). The *Acticon* court also addressed the lack of guidance from federal appellate courts regarding the proper standard—Rules 8(a)(2) or 9(b) of the Federal Rules of Civil Procedure—plaintiffs must satisfy when pleading economic loss. *See id.* at 38 (refraining from resolving applicable-standard ambiguity because outcome not dependent on ambiguity). This Case Comment, like the Second Circuit's decision, notes this unresolved issue, but considers it to be outside of its scope.

36. *See id.* at 38-39 (citing intra-circuit decisions applying out-of-pocket damages and later adoption by Supreme Court). Under the out-of-pocket measure, the difference between the price paid and the "value" of the stock when purchased equals the damages incurred. *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 168-69 (2d Cir. 1980) (listing and defining various alternative measures of damages). In the PSLRA, Congress imposed a cap on the damages available in securities fraud actions by limiting their calculation to no more than the difference between the purchase price and the mean trading price over a ninety-day period beginning when the corrective disclosure is made. *See* 15 U.S.C. § 78u-4(e)(3) (2012) (defining "mean trading price" as average of security's closing price each day over look-back period). In contrast to the Second Circuit's analysis, neither the district court nor *Malin*—the case that first interpreted *Dura* to preclude Rule 10b-5 claims in circumstances involving post-fraud-disclosure recovery—discussed the measure or calculation of Rule 10b-5 damages at all. *See generally In re* China N.E. Petrol. Holdings Ltd. Sec. Litig., 819 F. Supp. 2d 351 (S.D.N.Y. 2011) (neglecting discussion of calculation of damages), *vacated and remanded sub nom.* Acticon AG v. China N.E. Petrol. Holdings Ltd., 692 F.3d 34 (2d Cir. 2012); Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089 (D. Conn. Sept. 1, 2005) (neglecting discussion of calculation of damages).

37. *See* 692 F.3d at 39-40 (noting narrowness of Supreme Court's holding in *Dura*). The court characterized the reasoning employed by the district court as being inconsistent with the traditional measurement of damages and an unprecedented limitation on damage calculations. *See id.* (holding Acticon satisfied *Dura's* pleading requirements).

38. *See id.* at 39-41 (considering both legal and policy implications of Rule 10b-5's damages measurement). This section of the opinion contains a noticeable dearth of precedential references, as the court appeared to establish certain policy grounds for its holding outside of recent securities fraud precedent. *See id.* at 41 (evaluating comparative equities of alternative treatments of price recovery). When discussing the unique character of stock ownership, however, the court quoted a thirty-eight-year-old case from the Eighth Circuit that described the decision not to sell one's stock after post-fraud-disclosure recovery in price as "a second investment decision unrelated to his initial decision to purchase the stock." *See id.* at 41 (quoting Harris v. Am. Inv. Co., 523 F.2d 220, 228 (8th Cir. 1975) (internal quotation marks omitted)). The court in *Acticon* also asserted that the PSLRA's bounce-back provision was Congress's attempt to more accurately calculate the

court's analysis as overly simplistic, arguing that offsetting post-fraud-disclosure gains in share price against the actual losses Acticon had experienced as a direct result of NEP's allegedly fraudulent activity would have placed Acticon in a worse position than if the fraud had never occurred.[39] The Second Circuit went on to hold that evidence of share price recovery does not necessarily negate an inference of economic loss at the pleading stage of Rule 10b-5 claims.[40]

The *Acticon* court correctly ruled that share price recovery does not preclude a successful demonstration of economic loss.[41] Nevertheless, by asserting that the district court's measure of damages is inconsistent with PSLRA's bounce-back provision, the court left its holding vulnerable to attack on precisely the same grounds.[42] On one hand, the Second Circuit stressed the possibility that stock prices may increase while the negative effects of corrective disclosures simultaneously run their course.[43] On the other hand, the court also stressed that day-to-day market volatility should not be used to skew the calculation of available damages by citing the PSLRA's use of the mean trading price over the ninety-day period as the benchmark for Rule 10b-5 damages to bolster its point.[44] The incongruity of these assertions is apparent if one considers the practical scenario in which public revelation of a securities fraud negatively impacts the stock's immediate closing price, yet entirely unrelated forces ultimately result in a mean trading price that is greater than the plaintiff's purchase price.[45] Here, the PSLRA's bounce-back provision would outright

dollar amount of damages a plaintiff is entitled to using the out-of-pocket method. *See id.* at 39.

39. *See id.* at 41 (observing differences between shares regaining value after disclosure and shares never losing value). The Second Circuit described the lower court's analysis as "tak[ing] two snapshots of the plaintiff's economic situation and equat[ing] them without taking into account anything that happened in between . . . ." *Id.*

40. *See id.* at 41 (declining to draw inferences against plaintiff without more information).

41. *See* 692 F.3d at 40 (inferring economic loss because plaintiff alleged *both* purchase price and subsequent post-disclosure drop). The court made clear that its treatment of price recovery, which is favorable to plaintiffs, applies *only* in the context of the pleadings stage, and that it may be proper to offset recovery against losses upon further examination. *See id.* at 41 (searching for reasons behind intervening gains).

42. *See id.* at 39, 41 ("The limitation upon damages imposed by the District Court . . . is inconsistent with . . . the 'bounce back' cap imposed in the PSLRA."). The court specifically refers to the *Malin* court's interpretation of *Dura* as inconsistent with the PSLRA provision. *Compare id.* at 41 (declaring inability to realize unrelated gain as actionable loss), *with* Malin v. XL Capital Ltd., No. 3:03 CV 2001 PCD, 2005 WL 2146089, at *4 (D. Conn. Sept. 1, 2005) (requiring actual realization of economic loss for actionable claim).

43. *See* 692 F.3d at 41 (describing plaintiffs' loss as inability to profit from unrelated gain). In *Dura*, the Supreme Court acknowledged, albeit in dicta, the possibility that a plaintiff's loss could take the form of unrealized gains when it noted, "[t]he same is true in respect to a claim that a share's higher price is lower than it would otherwise have been—a claim we do not consider here." Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 343 (2005).

44. *See* 692 F.3d at 39, 41 (analyzing Rule 10b-5 damages independently of unrelated market forces).

45. *See* Transcript of Oral Argument at 7-11, Dura Pharm., Inc. v. Broudo, 544 U.S. 336 (2005) (No. 03-932) (presenting hypothetical during questioning of counsel). Oral arguments from *Dura* described such a scenario in which public revelations of securities fraud negatively affect the share price, but unrelated positive forces keep the stock from ever falling below purchase price, and can be summarized as follows: A company

preclude recovery of the economic losses identified in *Acticon*, thereby undercutting much of the court's rationale for reversing the long line of contrary trial-court rulings.[46]

The Second Circuit should have considered the PSLRA's bounce-back provision as a legislatively-imposed cap on recoverable damages under Rule 10b-5 and nothing more.[47] Indeed, the statute's plain language reveals its true function as a congressionally-mandated ceiling on damages that has no role in calculating the damage figure itself.[48] The Supreme Court has also made clear that a plaintiff is entitled to recover the diminution in value "actually cause[d]" by a defendant's fraud, but it remained tellingly silent on what effects, if any, the bounce-back provision has on the elements of loss causation and economic loss in Rule 10b-5 actions.[49]

By arguing that the district court's measure of damages must be logically consistent with the PSLRA's bounce-back provision in any way other than prohibiting an awarded amount from exceeding the statutory cap, the Second Circuit attributed improper legal significance to the statute.[50] Consequently, the PSLRA's bounce-back provision might now be used to support the notion that recovery for economic losses following a temporary recovery in the stock's price is also inconsistent with the PSLRA's cap on damages.[51] Thus, the Second Circuit correctly reversed the trial court's dismissal on the grounds that traditional, out-of-pocket damage measures combined with the unique characteristics of stock ownership demand as much, but its mischaracterization of the PSLRA's statutory damages cap left its rationale vulnerable to contradiction.[52]

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announces they have found gold, and the stock price accordingly increases from $10 to $60; an investor purchases the stock at $60 per share; the company discloses it had found not gold, but platinum; the stock price increases to $200; the investor brings a claim for the difference between the value of her shares at the $200 market price and the value if there had not been the disclosure regarding the absence of gold. *See id.*

46. *See* 692 F.3d at 39 (citing *In re* Mego Fin. Corp. Sec. Litig., 213 F.3d 454, 461 (9th Cir. 2000)).

47. *See id.* at 39 (characterizing bounce-back provision as calculation of damages allowing securities opportunity to recover). Portions of the opinion describe the bounce-back provision as merely a limit on the damages that can be ordered, and in other sections, as being related to the method of calculating the actual damages caused by the fraud. *Compare id.* at 38 ("Congress included a 'bounce back' provision that caps the amount of damages available in a securities fraud action."), *with id.* at 41 (arguing against district court's reasoning regarding loss realization because of inconsistency with bounce-back provision).

48. *See* 15 U.S.C. § 78u-4(e)(1) (2012) ("[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 . . . .").

49. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345-46 (2005) (establishing requirement of loss causation without mention of bounce-back provision).

50. *See* 692 F.3d at 38-41 (articulating simple utility and purpose of statute and attributing excessive substantive force to it).

51. *See In re* Mego Fin. Corp. Sec. Litig., 213 F.3d 454, 461 (9th Cir. 2000) ("[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.").

52. *See* 692 F.3d at 41 (overturning district court decision for failure to acknowledge unrealized price increase as economic loss).

In *Acticon AG v. China North East Petroleum Holdings Ltd.*, the Second Circuit considered whether Rule 10b-5's economic loss requirement precluded Acticon's private securities fraud claim for failing to sell its securities above the purchase price after it learned of NEP's fraudulent activities. The court properly ruled that a post-disclosure recovery in share price does not necessarily bar suits under Rule 10b-5 for lack of ability to show economic loss because the causal connection to any increases in share price could not possibly be established at the pleading stage. However, by using the PSLRA's bounce-back provision to support its holding, the Second Circuit provided ample grounds for the same issue to be decided differently in other circuits.

James M. Alexander