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Securities Fraud Litigation - Lost in Causation: Investors Not Entitled to Presumption of Loss Causation in Fraud-on-the-Market Cases-Dura Pharmaceuticals, Inc. v. Broudo, 125 S. Ct. 1627 (2005)

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**SECURITIES FRAUD LITIGATION – LOST IN
CAUSATION: INVESTORS NOT ENTITLED TO
PRESUMPTION OF LOSS CAUSATION IN FRAUD-ON-
THE-MARKET CASES – *DURA PHARMACEUTICALS,
INC. v. BROUDO*, 125 S. CT. 1627 (2005)**

To protect investors, the federal securities laws provide for a private cause of action when a company has engaged in fraud.¹ In particular, investors can recover where the company has made any “untrue statement of material fact” or has omitted any material fact “necessary in order to make the statements made...not misleading.”² To be successful in such an action, investors must prove, among other elements, that the defendant’s fraud caused their economic loss.³ In *Dura Pharmaceuticals v. Broudo*,⁴ the United States Supreme Court considered whether investors are entitled to a presumption of loss causation, requiring only that they establish that the price of the security on the date of purchase was inflated because of the misrepresentation.⁵ In rejecting such a presumption, the Court held that investors must specifically prove that the defendant’s misrepresentation caused the loss for which they seek to recover.⁶ Investors must now allege and prove not that the misrepresentation caused inflation of the security’s price, but rather that the misrepresentation caused a subsequent decline in its price.⁷

¹ See *infra* note 21 and accompanying text (discussing section 10(b) of Securities and Exchange Act and Rule 10(b)-5 promulgated thereunder).

² See *infra* note 21 and accompanying text (discussing private cause of action for securities fraud).

³ See 15 U.S.C. § 78u-4(b) (2005) (outlining statutory requirements for pleading securities fraud in private causes of action).

⁴ 125 S. Ct. 1627 (2005).

⁵ 125 S. Ct. at 1629 (quoting *Broudo v. Dura Pharm., Inc.*, 339 F.3d 933, 938 (9th Cir. 2003), *rev’d*, 125 S. Ct. 1627 (2005)) (noting that Ninth Circuit adopted the “on the date of purchase” position).

⁶ See 125 S. Ct. at 1633 (explaining that relevant statute expressly imposes burden on investors). Investors have “‘the burden of proving’ that the defendant’s misrepresentations ‘caused the loss for which they seek to recover.’” *Id.* (quoting 15 U.S.C. § 78u-4(b)(4)).

⁷ See 125 S. Ct. at 1633 (stressing legislative intent to only allow recovery where investors allege and prove traditional elements of causation and loss). The Court contrasted the legislative intent with the Ninth Circuit’s approach which allowed “recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss.” *Id.*

Dura Pharmaceuticals, Inc. ("Dura") develops and markets pharmaceutical products for the treatment of allergies, asthma, and other respiratory conditions.⁸ During the late 1990s, Dura was in the process of developing Spiros, a drug delivery system for asthma patients.⁹ As Dura was conducting clinical trials of Spiros, the plaintiffs purchased stock in the company.¹⁰ The plaintiffs purchased their shares between April 15, 1997 and February 24, 1998, during which time Dura's stock price climbed from \$28.00 to \$39.00 per share.¹¹ Over this period, Dura issued several press releases (the "1997 Press Releases") about Spiros and one of its other products, Ceclor.¹² In these announcements, Dura claimed that it would complete satisfactory testing of Spiros and soon receive Food and Drug Administration ("FDA") approval, and would see increasing sales of its respiratory drug Ceclor.¹³ However, on the last day of the class period, February 24, 1998, Dura announced that its earnings would be lower than expected, primarily because of slow drug sales, particularly of Ceclor.¹⁴ On February 25, Dura's stock price plunged from \$39.00 to \$20.00, a 47% one-day loss.¹⁵ Dura's business continued to decline throughout 1998 and in November, the company announced that Spiros would not receive FDA

⁸ See *In re Dura Pharm., Inc. Sec. Litig.*, No. 39, 2000 WL 33176043, at *1 (S.D. Cal. July 11, 2000) (discussing Dura's business strategy), *rev'd sub. nom.* *Broudo v. Dura Pharm., Inc.*, 339 F.3d 933 (9th Cir. 2003), *rev'd*, 125 S. Ct. 1627 (2005). Dura focused its business on purchasing the marketing rights to drugs that large pharmaceutical companies could no longer sell profitably. *Id.* at *1. Dura also began developing certain pharmaceutical products, including a drug delivery system to provide a uniform dose of asthma medication to patients. *Id.* It expected this drug delivery system, Spiros, to promote growth in the company's business. *Id.*

⁹ See *supra* note 8 and accompanying text (explaining Spiros drug delivery system).

¹⁰ See *In re Dura*, 2000 WL 33176043, at *1 (noting that plaintiffs purchased shares of Dura between 1997 and 1998); *infra* note 11 and accompanying text (detailing the movements of Dura's stock price during that time).

¹¹ *In re Dura*, 2000 WL 33176043, at *1, *4 (chronicling movements of Dura's stock price). Dura's stock was at a record high of \$47^{7/8} on December 31, 1996, but by April 14, 1997 (the day prior to the class period), it had fallen to \$27^{7/8} amid concerns over Dura's ability to introduce Spiros by late 1998 or early 1999. *Id.* at *1. However, by February 24, 1998 (the last day of the class period), it had climbed back to \$39^{1/8}. *Id.* at *4.

¹² See *Broudo*, 339 F.3d at 935 (summarizing key statements made by Dura and its executives during class period).

¹³ See *id.* (discussing Dura's press releases). In various press releases, Dura made statements to the effect that Spiros was on track for FDA approval and that its respiratory antibiotic Ceclor CD was experiencing strong sales and had increased its market share significantly. *Id.* at 935-36. Such press releases were issued on April 15, 1997; June 5, 1997; July 15, 1997; October 14, 1997; November 10, 1997; and January 20, 1998. *Id.*

¹⁴ See 125 S. Ct. at 1630 (outlining timeline of class period).

¹⁵ See *Broudo*, 339 F.3d at 936 (noting that Dura's stock decreased from \$39^{1/8} on February 24, 1998 to \$20^{3/4} on February 25, 1998).

approval.¹⁶ With this announcement, Dura's stock price further declined, but eventually recovered the following week.¹⁷

In their complaint, the plaintiffs claimed that Dura and its executives knew that the content of its 1997 Press Releases was false.¹⁸ In particular, the plaintiffs alleged that Dura issued the 1997 Press Releases to persuade investors that its drug sales were increasing and that it was successfully completing the development and testing of Spiros; when in fact, the company knew both to be untrue.¹⁹ According to the plaintiffs, the issuance of the 1997 Press Releases was a scheme by Dura's executives to bolster the company's stock price.²⁰ The plaintiffs filed several class actions claiming that Dura violated Section 10(b) of the Securities and Exchange Act and Rule 10b-5, promulgated thereunder by the Securities and Exchange Commission ("SEC").²¹ The District Court for the Southern District of California dismissed the complaint finding that the plaintiffs had not properly alleged the loss causation element of a Section 10(b) and Rule 10(b)-5 action.²² The district court focused on the last day of the class pe-

¹⁶ See *id.* (explaining that FDA did not approve Spiros because of reliability, chemistry, manufacturing, and control issues).

¹⁷ See 125 S.Ct. at 1630 (referencing plaintiff's complaint).

¹⁸ See *Broudo*, 339 F.3d at 936 (revealing that Dura knew as early as December 1997 that sales of several products, including Ceclor were actually declining). Dura executives revealed this information to stock analysts in an April 1998 meeting following the decline in its business. *Id.*

¹⁹ See *In re Dura Pharm., Inc. Sec. Litig.*, No. 39, 2000 WL 33176043, at *2 (S.D. Cal. July 11, 2000) (describing plaintiff's allegation that Dura began a concerted campaign in April 1997 to deceive investors to drive its stock price higher).

²⁰ See *id.* at *2 (claiming Dura's executives needed to drive up company's stock price to accomplish a significant debt offering to raise capital for Spiros' development). The plaintiffs contended that Dura learned of Spiros' reliability problems (which eventually became the basis of the FDA's rejection) during its Stage III clinical trials between December 1996 and March 1997. *Id.* at *1; see also *supra* note 19 and accompanying text (explaining the plaintiffs' "concerted campaign" theory).

²¹ See 15 U.S.C. §§ 78j(a)-(b), 78u-4(b) (2005) (providing private cause of action for securities fraud). Section 10(b) of the Securities and Exchange Act provides a private cause of action in instances where a defendant "use[d] or employ[ed]...any... manipulative or deceptive device,"... "in connection with the purchase or sale of any security" and "in contravention of" Securities and Exchange Commission "rules or regulations." 15 U.S.C. § 78j(a), (b). The Securities and Exchange Commission ("SEC") adopted Rule 10b-5, which prohibits the making of any "untrue statement of material fact" or the omission of any "material fact necessary in order to make the statements made... not misleading." 17 C.F.R. § 240.10b-5 (2005); see also *Broudo*, 339 F.3d at 936 (noting that several class actions were consolidated to form present action).

²² *Broudo*, 339 F.3d at 937 (citing *In re Dura*, 2000 WL 33176043, at *12). The district court instructed the plaintiffs to amend their complaint to "set forth each allegedly false or misleading statement or omission." *Id.* at 936. The plaintiffs were told to specify which of Dura's executives "made the statements and knew the 'true facts' that should have been disclosed." *Id.* Although the plaintiffs amended their complaint, it was subsequently dismissed by the district court for lack of loss causation. *Id.* The complaint stated merely that "in reliance on the integrity of the market, [the plaintiffs]...paid artificially inflated

riod, February 24, 1998, and stressed that the complaint did not establish that the "FDA's non-approval of [Spiros] had any relationship to the February price drop."²³ The Court of Appeals for the Ninth Circuit reversed, finding that the complaint adequately alleged "loss causation."²⁴ According to the Ninth Circuit, "plaintiffs establish loss causation if they have shown that the price *on the date of purchase* was inflated because of the misrepresentation."²⁵

Under the federal securities laws, investors may file a private cause of action where a company has made any untrue statement of material fact.²⁶ In filing such an action, investors must prove several elements, one of which is causation.²⁷ The causation element has two parts; it includes both transaction causation, also known as reliance, and loss causation.²⁸

prices for Dura securities' and the plaintiffs suffered 'damage[s]' thereby." 125 S. Ct. at 1630 (quoting Plaintiffs' amended complaint at 139a). The district court also dismissed the plaintiffs' complaint related to Dura's profitability statements about its Ceclor drug. *Broudo*, 339 F.3d at 937. In this regard, it found that the complaint failed to allege an appropriate state of mind (i.e. that Dura's executives acted knowingly). 125 S. Ct. at 1630.

²³ *Broudo*, 339 F.3d at 937 (citing *In re Dura*, 2000 WL 33176043, at *15) (noting that complaint did not explain how the alleged misrepresentations concerning Spiros "touched" upon the reasons for Dura's stock price decline). According to the district court, the reason for the decline in Dura's stock price was because of low revenues. *Id.*

²⁴ 125 S.Ct. at 1630.

²⁵ *Broudo*, 339 F.3d at 938 (quoting *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (emphasis in original) (allowing plaintiffs to sustain section 10(b) and Rule 10(b)-5 action if they identify the cause of the inflated price)).

²⁶ See *supra* note 21 and accompanying text (citing statutory text of section 10(b) and Rule 10(b)-5).

²⁷ See T. Hazen, *Law of Securities Regulation*, §12.11[1], [3] (5th ed. 2002) (discussing loss causation element of action under Section 10(b) and Rule 10(b)-5). In addition to loss causation, investors must prove that (1) the company made a material misrepresentation; (2) the company made the misrepresentation knowingly or with "scienter"; (3) the company made the misrepresentation in connection with the purchase or sale of a security; (4) the investors relied on the misrepresentation and (5) as a result of the transaction, the investors suffered an economic loss. See 15 U.S.C. § 78u-4(b)(4); see, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32, 248-49 (1988) (developing fraud-on-the-market theory of reliance); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (establishing scienter requirement); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975) (limiting recovery to actual purchasers or sellers).

²⁸ See *Binder v. Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999) (citing *McGonigle v. Combs*, 968 F.2d 810, 820 (9th Cir. 1992)). In a traditional reliance case, investors must show that they would not have purchased or sold the securities had they known of the adverse material fact. See Merritt B. Fox, *Demystifying Causation in Fraud-on-the-Market Actions*, 60 BUS. LAW. 507, 514 (2005). Essentially, investors must show that "but for" the company's misstatement they would not have purchased or sold the securities in question. *Id.* at 507, 514. However, in *Basic*, the Supreme Court upheld an alternative way of establishing reliance; the Court approved the "fraud-on-the-market" theory as the basis of a rebuttable presumption of reliance. See *Basic*, 485 U.S. at 249. According to the Court, "an investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be

Loss causation requires investors to establish a connection between the company's misrepresentation and their economic loss.²⁹

Over time, courts developed various theories for establishing loss causation in fraud-on-the-market cases.³⁰ Some courts focused on the date of realization—when the market learned of the company's fraud—and required a showing that the price dropped on that date because of the misrepresentation.³¹ Other courts focused on the date of purchase—when investors purchased their shares—and required a showing that the price was inflated on that date because of the misrepresentation.³² The Court of Appeals for the Second Circuit followed the on-the-date-of-realization or “causal connection” theory in *Emergent Capital*.³³ In that case, the Second Circuit rejected the on-the-date-of-purchase theory as being nothing more than paraphrased transaction causation.³⁴ According to the court, the on-the-date-of-purchase theory explained why investors purchased their shares, but not why they lost money on the transaction.³⁵ The court held that investors must answer the latter question—why they lost money on the transaction—to be successful in proving loss causation.³⁶ Thus, the court required investors to show that the ultimate decline in the security's price

presumed for purposes of a Rule 10B-5 action.” *Id.* at 247. Thus, in fraud-on-the-market cases, investors must show that the company's misstatement caused them to pay a higher price, not that it caused them to purchase the security in the first instance. *See Fox, supra* note 28, at 507.

²⁹ *See supra* notes 27 and 28 and accompanying text (discussing loss causation and reliance elements of securities fraud actions).

³⁰ *See, e.g., Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003) (requiring causal connection); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000) (requiring causal connection); *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990) (requiring causal connection); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003) (following price inflation theory); *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (following price inflation theory); *Robbins v. Koger Prop., Inc.*, 116 F.3d 1441, 1447-48 (11th Cir. 1997) (requiring causal connection); *see also Binder*, 184 F.3d at 1066.

³¹ *See Fox, supra* note 28, at 517 (discussing cases requiring traditional showing of loss causation); *see, e.g., Semerenko*, 223 F.3d at 185; *Robbins*, 116 F.3d at 1448.

³² *See Fox, supra* note 28, at 517 (noting cases that follow price inflation theory of loss causation); *see, e.g., Gebhardt*, 335 F.3d at 831; *Knapp*, 90 F.3d at 1438.

³³ *See Emergent Capital*, 343 F.3d at 198 (holding that price being inflated on date of purchase was not sufficient); *see also supra* notes 30 and 31 and accompanying text (citing cases that required causal connection).

³⁴ *See Emergent Capital*, 343 F.3d at 198 (explaining on-the-date-of-purchase theory).

³⁵ *See infra* note 39 and accompanying text (supporting theory that investors' injury occurs when they purchase the security).

³⁶ *See supra* note 34 and accompanying text (calling on-the-date-of-purchase theory paraphrased transaction causation).

was reasonably related to the company's correction of its misstatement or omission.³⁷

In contrast, the Court of Appeals for the Ninth Circuit followed the latter on-the-date-of-purchase or "price inflation" theory, and allowed investors to establish loss causation by showing merely that the company's misrepresentation "touched upon" the reasons for the security's decline in price.³⁸ As such, for fraud-on-the-market cases, the Ninth Circuit only required investors to prove that the price on the date of the purchase was inflated because of the misrepresentation.³⁹ The court did not require investors to show that the price declined *because of* the company's subsequent correction of its misrepresentation or omission.⁴⁰ It did not require any causal connection between the company's misrepresentation and the security's decline in price.⁴¹

In *Dura Pharmaceuticals v. Broudo*, the Supreme Court considered whether investors could establish loss causation by pleading that the price on the date of purchase was inflated because of the misrepresentation.⁴² In other words, the Court considered whether the latter price inflation theory of loss causation was permissible.⁴³ The Court correctly rejected such a theory, holding that something more was required.⁴⁴ With limited discussion, the court explained that investors have the burden of showing that the company's misrepresentation caused them some economic harm.⁴⁵ The Court stressed that the Ninth Circuit's theory was unacceptable because it allowed recovery where the misrepresentation caused price inflation, but nonetheless caused no economic harm.⁴⁶

³⁷ See *Emergent Capital*, 343 F.3d at 198 (stressing need to show causal connection). "[S]ecurities fraud plaintiffs [must] demonstrate a causal connection between the content of the alleged misstatements or omissions and the 'harm actually suffered.'" *Id.*

³⁸ See *Binder v. Gillespie*, 184 F.3d 1059, 1066 (9th Cir. 1999) (quoting *McGonigle v. Combs*, 968 F.2d 810, 821 (9th Cir. 1992)).

³⁹ See *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (following theory that plaintiff's injury occurs on date of purchase).

⁴⁰ See *supra* notes 25, 38, and 39 and accompanying text (emphasis added) (discussing Ninth Circuit's on-the-date-of-purchase approach to determining loss causation).

⁴¹ See *supra* notes 38 and 39 and accompanying text (outlining how investors prove loss causation using price inflation theory).

⁴² See *supra* note 5 and accompanying text (summarizing Ninth Circuit's presumption of loss causation).

⁴³ See *supra* notes 30, 32, 38 and 39 and accompanying text (citing cases following price inflation theory).

⁴⁴ See *supra* notes 6 and 7 and accompanying text (requiring plaintiffs to show reason why price was inflated).

⁴⁵ See *supra* note 6 and accompanying text (requiring specific allegation of economic loss).

⁴⁶ See *supra* note 7 and accompanying text (stressing need to show why security declined in price).

The Court was correct in rejecting the Ninth Circuit's price inflation theory for two reasons.⁴⁷ First, the price inflation theory renders the loss causation element of securities fraud actions redundant to that of transaction causation.⁴⁸ Second, the theory disregards the purposes for which the loss causation element was developed.⁴⁹

Transaction causation and loss causation are distinct elements of securities fraud actions, and they are relevant at different points along the investors' timeline.⁵⁰ Transaction causation focuses on the market when the investor purchased the security-before the company's misstatement is disclosed.⁵¹ In contrast, loss causation should focus on the market at a later point-after the company's misstatement is corrected.⁵² The price inflation theory ignores this difference; it focuses on when the investor purchased the security for both transaction causation and loss causation, which the Court correctly found to be its fatal problem.⁵³

To establish transaction causation/reliance, investors may use the fraud-on-the-market presumption.⁵⁴ The fraud-on-the-market presumption assumes that the company's misstatement is reflected in the security's price and as such, that the investors paid a higher price for it.⁵⁵ The price inflation theory allows investors to use this same presumption in establishing loss causation; it allows investors to show merely that they paid a higher price for the security because of the misrepresentation and nothing more.⁵⁶ This renders the loss causation element redundant to that of transaction causation.⁵⁷ "If all [investors] ha[ve] to show...is that the misstatement inflated the price at the time of purchase, [they] do not need to show, as the traditional loss causation formulation requires, that [they] held [the

⁴⁷ See *infra* notes 48, 62, and 63 and accompanying text (discussing reasons for rejecting price inflation theory).

⁴⁸ See *Fox*, *supra* note 28, at 517 (clarifying that loss causation and transaction causation are two distinct elements of securities fraud actions).

⁴⁹ See *infra* notes 62-63 and accompanying text (describing purpose of loss causation element).

⁵⁰ See *supra* note 27 and accompanying text (outlining various elements of securities fraud actions).

⁵¹ See *supra* note 28 and accompanying text (explaining transaction causation).

⁵² See *supra* note 37 and accompanying text (requiring causal connection between company's misstatement and investor's loss).

⁵³ See *supra* note 39 and accompanying text (supporting theory that investor's injury occurs on date of purchase).

⁵⁴ See *supra* note 28 and accompanying text (noting development of fraud-on-the-market theory).

⁵⁵ See *supra* note 28 and accompanying text (clarifying transaction causation element).

⁵⁶ See *supra* note 48 and accompanying text (arguing that price inflation theory renders loss causation element meaningless).

⁵⁷ See *supra* note 48 and accompanying text (explaining that price inflation theory utilizes the same presumption for both transaction and loss causation).

security] until the point that the market realized the true situation.”⁵⁸ Under the price inflation theory, the investors’ injury occurs well before the market corrects itself; it occurs at the time of the transaction.⁵⁹ Thus, investors do not necessarily suffer a loss *after* the transaction, which is exactly what the loss causation element requires.⁶⁰

The loss causation element of securities fraud actions was established to assure that a company’s misrepresentation was in some way reasonably or proximately responsible for the investors’ economic loss.⁶¹ Courts created the loss causation element as a means of restricting liability, of requiring “something more” than just transaction causation.⁶² As stated by Merritt Fox in the article *Demystifying Causation in Fraud-on-the-Market Actions*,

If, to impose liability on a defendant, all that an investor has to show is that she was induced into purchasing shares by the defendant’s misstatement--i.e., transaction causation--the defendant would be insuring the plaintiff against every risk that could possibly depress price below the price paid at time of purchase, including risks totally unrelated to the misstatement. Loss causation is the requirement of “something more,” akin to proximate cause in negligence, that prevents such wide ranging liability.⁶³

The price inflation theory eliminates that “something more”; it allows investors to satisfy both transaction causation and loss causation by simply introducing evidence that the price was inflated.⁶⁴ However, the purpose of the loss causation element is not to prove that the misrepresentation caused the inflation of the security’s price, but rather to prove that it caused a *subsequent decline* in its price.⁶⁵ Section 10(b) and Rule 10(b)-5 are not intended to act as insurance for private investors; they are intended to pro-

⁵⁸ Fox, *supra* note 28, at 517-18 (arguing that loss causation element requires more than mere inflation in price).

⁵⁹ See *id.* (noting which dates are relevant to transaction causation and loss causation).

⁶⁰ See *supra* notes 27 and 28 and accompanying text (outlining securities fraud action and its various elements).

⁶¹ See Fox, *supra* note 28, at 511 (discussing case law that developed dual-framework of transaction and loss causation).

⁶² See *id.* at 515 (clarifying that action for securities fraud not intended as insurance against economic loss).

⁶³ See *id.* (noting that loss causation is poor fit in fraud-on-the-market cases).

⁶⁴ See *id.* (stressing that price inflation theory renders transaction and loss causation redundant).

⁶⁵ See *supra* note 7 and accompanying text (emphasis added) (explaining legislative intent to only allow recovery where investors prove traditional elements of causation and loss).

vide recovery where a company's fraudulent misrepresentation actually caused the investors' some economic loss.⁶⁶

In conclusion, in fraud-on-the-market cases, investors are not required to prove that the misrepresentation induced them to purchase the security. If the price inflation theory were adopted, investors would also not be required to prove that the misrepresentation caused them any economic harm. Such a result is contrary to the purposes of the federal securities laws and as recognized by the Supreme Court in *Dura Pharmaceuticals v. Broudo*, is not permissible.

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⁶⁶ See *supra* notes 27, 28, 62, and 63 (discussing claim of securities fraud and its intended purpose).

