

MEET TWO-FACE: THE DUALISTIC RULE 10b-5 AND THE QUANDARY OF OFFSETTING LOSSES BY GAINS

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The challenge of calculating damages in securities litigation is often compounded by the phenomenon of investors that have accrued both gains and losses as a result of the defendant company's same fraudulent misrepresentations. This Note traces the opposing damages approaches and accounting methods courts have adopted in these instances to the dual origins and objectives of the Rule 10b-5 private right of action. Underscoring the shortcomings in these damages calculations founded predominantly upon either deterrent or compensatory grounds, this Note instead strives for a measure that not only balances both imperative ends but also yields a more sensible and equitable outcome. Namely, this Note proposes that losses should only be offset by gains when they are sufficiently linked by an ongoing trading strategy, and that matching sales of securities with the latest purchases will most clearly reflect gains and losses during the class period.

INTRODUCTION

After a criminal disfigures half of Harvey Dent's face with acid, the once District Attorney of Gotham City and ally of Batman goes insane and becomes the crime boss Two-Face.¹ As a result of his extreme multiple personality disorder, Two-Face makes all important decisions by flipping a two-headed coin.² Although attempts are made to surgically repair Harvey Dent's facial scars, they can never cure his inner obsession with duality.³

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1. See Bill Finger, Bob Kane, Jerry Robinson & George Roussos, *Meet Two-Face*, DETECTIVE COMICS 66, at 2–5 (DC Comics Aug. 1942), reprinted in BATMAN ARCHIVES, VOLUME TWO 220–23 (DC Comics 1991) (first appearance of Two-Face).

2. See *id.*

3. See Jeph Loeb, Jim Lee & Scott Williams, *Batman: Hush*, DETECTIVE COMICS 616, at 9–10 (DC Comics Aug. 2003); Frank Miller, Klaus Janson & Lynn Varley, *Batman: The Dark Knight Returns*, DETECTIVE COMICS, at 15–17 (DC Comics Feb. 1986); Bill Finger, Bob Kane, Jerry Robinson & George Roussos, *The End of Two-Face*, DETECTIVE COMICS

In much the same way, the courts have habitually flipped a two-headed coin—deterrence on one side and compensation on the other—to decide the primary objective underlying the most potent private remedy for fraud available under section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and Securities and Exchange Commission (SEC) Rule 10b-5.⁴ In the typical Rule 10b-5 action, the plaintiff must show that, as a result of alleged misrepresentations and in reliance on an honest market, he purchased shares of stock that, when the alleged fraud was revealed, were worth less than he had paid for those same shares.⁵ While the securities laws generally measure damages by the impact of the defendant's misrepresentations on the market value of the stock owned or exchanged,⁶ the commonly forsaken yet inescapable duality of Rule 10b-5 has led to “a confused area of the law where the courts, forced to rely on their own wits, have crafted a myriad of approaches” to calculate damages.⁷

This Note focuses on the conflict between the dual objectives of Rule 10b-5 that materializes in deciding whether to offset an investor's losses by gains resulting from the same misrepresentations. Part I summarizes the common investment transactions and strategies that give rise to such scenarios, elaborates on the origins and elements of the Rule 10b-5 private right of action, and contrasts the seminal cases addressing the elements of reliance and loss that have seesawed on its primary objective.⁸ Rule 10b-5 springs from the Exchange Act, enacted in the wake of the stock market crash of 1929 to deter fraud and protect the integrity of the market, in which case violators ought to be penalized regardless of the ultimate harm inflicted on investors.⁹ At the same time, the private right of action implied from Rule 10b-5 is modeled after common law tort actions meant to compensate victims, in which case investors' damages awards should be limited to their actual harm suffered.¹⁰ Although deterrence and compensation can theoretically blend to achieve optimal damages, most federal courts encountering the problem of gains and losses have considered these objectives mutually exclusive on the assumption that maximizing damages would provide greater deterrence whereas moderating damages would produce fairer compensation.¹¹

Arising from this prevalent “either/or” outlook in cases involving gains and losses, Part II delineates the opposing damages approaches that federal

80, at 12 (DC Comics Oct. 1943), *reprinted in* BATMAN ARCHIVES, VOLUME THREE 142 (DC Comics 1994).

4. *See* 3 THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 12.4 (5th ed. 2005); 26 MICHAEL J. KAUFMAN, *SECURITIES LITIGATION: DAMAGES* § 9:1 (2007).

5. *In re Cigna Corp. Sec. Litig.*, 459 F. Supp. 2d 338, 349 (E.D. Pa. 2006).

6. *See* 26 KAUFMAN, *supra* note 4, § 1.4.

7. *See* 5 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD* § 8:1 (2d ed. 2008) (quoting *Koch v. Koch Indus., Inc.*, 6 F. Supp. 2d 1192, 1201 (D. Kan. 1998)).

8. *See infra* Part I.A–C.

9. *See infra* Part I.C.

10. *See infra* Part I.C.

11. *See infra* Part I.C–D.

courts have taken in deciding whether to offset losses by gains as well as the accounting methods used to match purchases and sales of securities to compute those gains and losses in the first place. Courts emphasizing the compensation objective have taken a netting approach to damages that offsets gains and losses stemming from different transactions, while courts stressing the deterrence objective have taken a transactional approach that considers each transaction individually and allows the plaintiff to recover all losses without any offset for gains.¹² Correspondingly, the “first-in, first-out” accounting method tends to increase damages, thereby supporting the deterrence objective, while the “last-in, first-out” method tends to decrease potential damages, thus aligning with the compensation objective.¹³ A modern trend among courts within the U.S. Court of Appeals for the Third Circuit to decide whether to offset losses by gains on a case-by-case basis has paved the way for a more comprehensive approach to damages, but properly assessing the accounting methods used to match purchases and sales of securities demands a separate inquiry into the extent of the relationship between the law and accounting.¹⁴

That said, Part III expands on the Third Circuit’s newfound approach to offsetting losses by gains and examines the methods used to compute gains and losses in light of accepted accounting principles and standards. Based on two recent Third Circuit cases, this Note proposes a damages approach that distinguishes between ongoing and independent trading strategies in determining whether to offset losses by gains.¹⁵ In so doing, the dual objectives of Rule 10b-5 cannot only be harmonized, but can also achieve together more equitable damages calculations.¹⁶ Irrespective of the damages approach chosen, this Note also argues that the “last-in, first-out” method, which generally better reflects periodic income, is especially appropriate in Rule 10b-5 actions.¹⁷ That taxpayers may not use this method to match purchases and sales of securities and that it may also soon be prohibited for physical inventories for both financial reporting and tax purposes do not necessarily justify supplanting the method that is otherwise most suitable for Rule 10b-5 actions.¹⁸

In promoting a damages calculus for Rule 10b-5 cases involving gains and losses, this Note also aims, in general, to dispel the widely held conception of deterrence and compensation as mutually exclusive objectives. While they may appear to clash at times, deterrence and compensation are ultimately just two sides of the same coin that together inspire the Rule 10b-5 private right of action.

12. *See infra* Part II.A.1–2.

13. *See infra* Part II.B.1–2.

14. *See infra* Part II.A.3, B.3.

15. *See infra* Part III.A.

16. *See infra* Part III.A.

17. *See infra* Part III.B.

18. *See infra* Part III.B.

I. TWO FACES

Assessing investors' losses in Rule 10b-5 actions to determine the lead plaintiff or to calculate final damages awards, like any quantification of economic loss, can be a challenging task for courts.¹⁹ To begin with, a relative paucity of decisions actually reach the question of damages because most securities litigation does not proceed to final judgment on the merits, and the courts considering damages have taken numerous approaches.²⁰ Further complicating damages calculations, this part highlights some common investment transactions and strategies, such as short selling and market timing, which often come up in Rule 10b-5 actions.²¹ Consequently delving into the Rule 10b-5 private right of action's statutory and judicial origins as well as the parameters of its essential elements, courts have wound up vacillating between deterrence and compensation as the primary objective.²² These two faces of the courts are most glaringly exemplified

19. See 3 HAZEN, *supra* note 4, § 12.12. Since many courts and commentators often use "damages," "economic loss," and a variety of other similar terminologies loosely and interchangeably (even though these terms may technically have distinct legal and economic meanings) when discussing both the largest financial interest for presumptive lead plaintiff and the amount class members would be entitled to receive if the plaintiffs win the case at trial, this Note likewise does not distinguish between them. Compare Frederick C. Dunbar & Marcia Kramer Mayer, *Dura and the New Vocabulary of Litigation Under Rule 10b-5*, NERA ECON. CONSULTING, Jan. 5, 2006, at Abstract, available at <https://plusweb.org/files/Events/all.stars6Dunbar-Mayer%20Dura%20Paper%20Jan2006.pdf> ("Dura does not specifically address damages, but it speaks of 'relevant economic loss' as if those terms were synonymous, implying that the amount of loss proximately caused by a fraud is the measure of Rule 10b-5 damages."), with Lawrence Sucharow & Christopher J. Keller, *FIFO vs LIFO: Different Ways to Calculate Shareholder Losses for Purposes of Adopting Lead Plaintiff Lead to Different Results*, INV. & PENSION EUR., May 2006, at 12 n.1, available at http://www.labaton.com/en/about/published/upload/IPE_Practical_steps_in_corporate_governance.pdf ("It is important to note that 'losses' for purposes of determining the lead plaintiff in a PSLRA action is *not* the same as 'damages', which is the amount of money that class members would be entitled to receive if the plaintiffs win the case at trial. Damages can be described as those losses that were actually caused by the fraud.").

20. See 3 HAZEN, *supra* note 4, § 12.12; 26 KAUFMAN, *supra* note 4, § 1:1 ("It is a rare case, and a rarer published opinion, which reaches the damages stage. The lack of attention to damages by the bar and the bench has produced a lack of clarity in the law of damages, particularly in areas already wrought with complexity. No area of the law is more complex than the regulation of securities transactions."); see also Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1423–24, 1426 (1994) (finding that the parties' calculations of damages are typically far apart, that these cases are likewise characterized by expert testimony that is inconsistent and partisan, and cautioning that "[i]f extreme divergence in damage estimates is not simply a trial tactic, but represents a fundamental lack of common ground as to how much is at stake if plaintiffs prevail on liability, it may have important implications for evaluating the effectiveness of class action litigation for enforcing the securities laws"); Kenneth R. Cone & James E. Laurence, *How Accurate Are Estimates of Aggregate Damages in Securities Fraud Cases?*, 49 BUS. LAW. 505, 506 (1994) (noting that the estimates produced by damage models influence settlement negotiations by shaping the parties' views of likely outcomes at trial and thus provide the foundation for settlement negotiations).

21. See *infra* Part I.A.

22. See *infra* Part I.B–C.

by the problem of calculating damages in cases involving gains and losses resulting from the same misrepresentations.²³

A. *The Long and Short of Investing*

Investors can buy or sell short equity securities, such as common stock, which represent ownership shares in a corporation.²⁴ The purchaser of common stock is entitled to a vote on corporate governance matters and to a share in the financial benefits of ownership.²⁵ Investors generally buy (“go long”) shares to profit on an increase in the stock’s price over time and to receive dividend income.²⁶ Conversely, a short sale is “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by . . . the seller.”²⁷ Anticipating that the price of a security will drop in value, short sellers will typically borrow the securities to be sold and later repurchase (“cover”) the same securities for return to the lender.²⁸ If the stock’s price falls as expected, short sellers profit from having sold the borrowed securities for more than they later pay, but if the stock’s price rises, short sellers lose by paying more for them than the price at which they sold them.²⁹

As distinguished from long and short investment transactions, investors also often engage in long-term or short-term investment strategies.³⁰ An investment strategy is a set of rules, behaviors, or procedures that guide an investor’s selection of an investment portfolio, usually designed around the investor’s risk-return trade-off.³¹ Passive long-term investment strategies, such as “buy-and-hold,” are based on the concept that in the long run equity

23. See *infra* Part I.D.

24. See ZVI BODIE, ALEX KANE & ALAN J. MARCUS, *INVESTMENTS* 44 (5th ed. 2002); GEOFFREY A. HIRT & STANLEY B. BLOCK, *FUNDAMENTALS OF INVESTMENT MANAGEMENT* 74 (The Wall St. J. ed., The McGraw Hills Companies, Inc. 1999) (1983).

25. See BODIE, KANE & MARCUS, *supra* note 24, at 44; ESMÉ FAERBER, *ALL ABOUT STOCKS: THE EASY WAY TO GET STARTED* 13 (3d ed. 2008).

26. See HIRT & BLOCK, *supra* note 24, at 74.

27. See Regulation of Short Sales, 17 C.F.R. § 242.200(a) (2007). Judge Richard Posner characterizes a short sale as “a sale at a price fixed now for delivery later.” *Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857, 859 (7th Cir. 1995); see also *Zlotnick v. TIE Commc’ns*, 836 F.2d 818, 820 (3d Cir. 1988) (describing short selling); *Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.*, 315 F. Supp. 2d 666, 670 (E.D. Pa. 2004) (same).

28. See BODIE, KANE & MARCUS, *supra* note 24, at 90; HIRT & BLOCK, *supra* note 24, at 74; see also James W. Christian, Robert Shapiro & John-Paul Whalen, *Naked Short Selling: How Exposed Are Investors?*, 43 HOUS. L. REV. 1033, 1038 (2006) (contrasting traditional short selling, which involves selling shares that the seller does not own but has borrowed with the requirement that the short seller purchase equivalent shares on the market and return them to the lender at a later date, with naked short selling, which involves investors who sell shares of stock they have not borrowed, have no intention of borrowing, and that may not even exist).

29. See BODIE, KANE & MARCUS, *supra* note 24, at 90–91; FAERBER, *supra* note 25, at 105–09; HIRT & BLOCK, *supra* note 24, at 74.

30. See BODIE, KANE & MARCUS, *supra* note 24, at 349; FAERBER, *supra* note 25, at 9.

31. See FAERBER, *supra* note 25, at 9.

markets give a good rate of return despite periods of volatility or decline.³² A strong argument for the buy-and-hold strategy is the efficient market hypothesis, which presumes that stock prices already reflect all available information.³³ Active short-term investment strategies, on the other hand, such as “market timing,” involve making buy or sell decisions of securities by attempting to predict future market price movements.³⁴ Whether market timing is ever a viable investment strategy is controversial, since the efficient market hypothesis suggests that share prices already reflect all relevant information, and prices often exhibit “random walk” behavior that cannot be predicted with consistency.³⁵

The prevalence of long and short investment transactions as well as long-term and short-term investment strategies has complicated damages calculations in Rule 10b-5 actions. While short selling is generally a legitimate transaction used to profit from an expected downward price movement or to hedge a risk of a long position, it is counterintuitive because the short seller is betting the stock will decline in value, whereas most investors take a long position and are looking for an increase in the stock’s price.³⁶ Obscuring matters further, investors engaging in short-term strategies might be executing thousands of transactions involving millions of shares in a company, and at any given time might be buying, selling, selling short, or purchasing to cover short sales.³⁷ Consequently, it is more

32. See BODIE, KANE & MARCUS, *supra* note 24, at 349 (noting that a common passive strategy is to invest in an index fund, which is a fund designed to replicate the performance of a broad-based index of stocks); JOEL GREENBLATT, *THE LITTLE BOOK THAT BEATS THE MARKET* 95 (2006) (“Over the short term, Mr. Market acts like a wildly emotional guy who can buy or sell stocks at depressed or inflated prices. Over the long run, it’s a completely different story: *Mr. Market gets it right.*”).

33. See BODIE, KANE & MARCUS, *supra* note 24, at 341. *But see* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 920 (1992) (contending that “we have gambled on a simplifying theory . . . in making judgments about securities law”).

34. See BODIE, KANE & MARCUS, *supra* note 24, at 917–23.

35. See *id.* at 341; BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 24 (2003) (“A random walk is one in which future steps or directions cannot be predicted on the basis of past actions. When the term is applied to the stock market, it means that short-run changes in stock prices cannot be predicted.”).

36. See *Rocker Mgmt., LLC v. Lernout & Hauspie Speech Prods. N.V.*, No. 00-5965 (PGS), 2007 WL 2814653, at *2 (D.N.J. Sept. 24, 2007); *see also* David A. Rocker, Managing Gen. Partner, Rocker Partners, L.P., Presentation to the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises: The Long and Short of Hedge Funds, Effects of Strategies for Managing Market Risk (May 22, 2003), available at <http://financialservices.house.gov/media/pdf/052203dr.pdf> (describing the importance that short selling plays in creating more liquid, balanced, and fair markets). A negative aspect of short selling, however, is that a holder of a substantial short position may artificially devalue a stock. See *Rocker*, 2007 WL 2814653, at *2; *Overstock.com, Inc. v. Gradient Analytics, Inc.*, 61 Cal. Rptr. 3d 29 (Ct. App. 2007) (involving an action for defamation and other torts brought by Overstock.com against a publisher of analytic reports on publicly traded companies and against Rocker, alleging defendants collaborated to produce custom negative reports on Overstock.com).

37. See *Rocker*, 2007 WL 2814653, at *15; *In re Cigna Corp. Sec. Litig.*, 459 F. Supp. 2d 338, 341 (E.D. Pa. 2006).

difficult to determine these investors' rights and liabilities using ordinary principles of securities law that were developed, for the most part, with conventional long investors in mind.³⁸

B. *The Rule 10b-5 Implied Private Right of Action*

Congress enacted the Exchange Act in response to widespread fraudulent and manipulative practices in the securities markets leading up to the stock market crash of 1929 and the Great Depression.³⁹ In contrast to the Securities Act of 1933, which is directed primarily at the distribution of securities, the Exchange Act regulates virtually all aspects of securities transactions and the securities markets generally.⁴⁰ The Exchange Act also created the SEC and governs its wide-ranging administrative authority.⁴¹ Violations of the federal securities laws give rise to criminal penalties, SEC civil enforcement actions and administrative proceedings, disciplinary actions by securities exchanges or national securities associations, and both express and implied private rights of action.⁴²

"Private federal securities fraud actions are based upon federal securities statutes and their implementing regulations."⁴³ The general antifraud provision of the Exchange Act contained in section 10(b) makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."⁴⁴ Pursuant to its authority under the Exchange Act, the SEC promulgated Rule 10b-5, which provides that it shall be unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading."⁴⁵

Courts have implied from section 10(b) and Rule 10b-5 a private damages action that "resembles, but is not identical" to common-law tort actions for deceit and misrepresentation.⁴⁶ The action's basic elements

38. See *Rocker*, 2007 WL 2814653, at *2.

39. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78mm (2006)); see 3 HOWARD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW* § 1:1 (2d ed. 2008) ("The history of securities regulation has largely conformed to a pattern of flagrant problems made evident by a financial crisis followed by retrospective investigations leading to the enactment of remedial legislation.").

40. See 1 HAZEN, *supra* note 4, § 1.2; 2 HAZEN, *supra* note 4, § 9.1.

41. See 2 HAZEN, *supra* note 4, § 9.1.

42. See 1 HAZEN, *supra* note 4, § 1.8.

43. *Dura Pharm., Inc., v. Broudo*, 544 U.S. 336, 341 (2005).

44. 15 U.S.C. § 78j(b).

45. 17 C.F.R. § 240.10b-5(b) (2008).

46. See *Dura*, 544 U.S. at 341; *Basic Inc. v. Levinson*, 485 U.S. 224, 230-31 (1988) ("Judicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of § 10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the [Exchange] Act's

include (1) a material misrepresentation (or omission), (2) scienter, i.e., a wrongful state of mind, (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation, i.e., a causal connection between the material misrepresentation and the loss.⁴⁷ Because the Rule 10b-5 remedy is not an express one, courts have faced some difficult questions that might otherwise have been answered in the statute, including the necessity of proof of reliance by the plaintiff on the misstatement or omission and the appropriate measure of damages.⁴⁸

C. *The Entangled Elements of Reliance and Loss*

1. Easing the Burden: *Basic* and the Rebuttable Presumption of Reliance

Determining the appropriate measure of damages cannot be separated from questions like reliance that go into determining whether liability exists.⁴⁹ An “essential” element of a Rule 10b-5 cause of action,⁵⁰ “reliance provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”⁵¹ Courts traditionally required purchasers and sellers of securities to establish that they were aware of, and directly misled by, an alleged misrepresentation to state a claim for securities fraud under Rule 10b-5.⁵² Over time, though, courts have recognized that there is “more than one way to demonstrate the causal connection.”⁵³ As the U.S. Supreme Court in *Basic Inc. v. Levinson*⁵⁴ acknowledged, “The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5’s reliance requirement must encompass these differences.”⁵⁵

In view of that, the Supreme Court established that an investor’s reliance on any public material misrepresentations may be presumed for a Rule 10b-5 action.⁵⁶ In *Basic*, former shareholders who sold their stock between Basic’s public denials of merger activity and the merger announcement

requirements.” (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975)).

47. See *Dura*, 544 U.S. at 341–42.

48. See 3 HAZEN, *supra* note 4, § 12.3[3]. Other important questions include the definition of materiality, the requisite causal connection, and the applicable statute of limitations. *Id.*

49. See 3B BLOOMENTHAL & WOLFF, *supra* note 39, § 13:42.

50. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008).

51. *Basic*, 485 U.S. at 243 (citing *Wilson v. Comtech Telecomms. Corp.*, 648 F.2d 88, 92 (2d Cir. 1981); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied sub nom. List v. Lerner*, 382 U.S. 811 (1965)).

52. See *Semerenko v. Cedant Corp.*, 223 F.3d 165, 178 (3d Cir. 2000).

53. *Basic*, 485 U.S. at 243.

54. 485 U.S. 224.

55. *Id.* at 243–44 (citing W. PAGE KEETON ET AL., PROSSER AND KEETON ON LAW OF TORTS 726 (5th ed. 1984)).

56. *Id.* at 247.

filed a class action against Basic, alleging that Basic's statements had been false or misleading, in violation of section 10(b) and Rule 10b-5, and that they were injured by selling their shares at prices artificially depressed by those statements.⁵⁷ In determining whether class certification was appropriate, the Supreme Court upheld the presumption of reliance, supported by the fraud-on-the-market theory,⁵⁸ instead of requiring each plaintiff to show direct reliance on Basic's statements.⁵⁹ The Court found that the presumption relieves the Rule 10b-5 plaintiff of an unrealistic evidentiary burden and advanced the Exchange Act's policies of requiring full disclosure and fostering reliance on market integrity.⁶⁰ The Court also considered the presumption rational, since an investor who trades stock at the price set by an impersonal market does so in reliance on the integrity of that price.⁶¹ The Court pointed out, however, that defendants may rebut the presumption of reliance by showing that the price was not affected by the defendant's misrepresentation, or that the plaintiff did not trade in reliance on the integrity of the market price.⁶²

A few months prior to the Supreme Court's decision in *Basic*, the Third Circuit in *Zlotnick v. TIE Communications*⁶³ ruled that short sellers have standing to sue under Rule 10b-5 but are not entitled to a rebuttable presumption of reliance.⁶⁴ Zlotnick claimed that defendants' misrepresentations artificially inflated the price of Technicom stock, which he had sold short, causing him to lose money when he made the purchase to cover the short sale.⁶⁵ Citing the Supreme Court's decision in *Blue Chip*

57. *Id.* at 228.

58. *Id.* at 250; Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986) (“The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. The misstatements may affect the price of the stock, and thus defraud purchasers who rely on the price as an indication of the stock's value. By artificially inflating the price of the stock, the misrepresentations defraud purchasers who rely on the price as an indication of the stock's value. The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations. In both cases, defendants' fraudulent statements or omissions cause plaintiffs to purchase stock they would not have purchased absent defendants' misstatements and/or omissions.” (citing Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143, 1154–56 (1982))).

59. *Basic*, 485 U.S. at 245–47; see also R. Douglas Martin, *Basic Inc. v. Levinson: The Supreme Court's Analysis of Fraud on the Market and Its Impact on the Reliance Requirement of SEC Rule 10B-5*, 78 KY. L.J. 403 (1990). But see A. C. Pritchard, *Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform*, 2008 CATO SUP. CT. REV. 217, 218 (arguing that the Court in *Basic* “misunderstood the function of the reliance element and its relation to the question of damages”).

60. *Basic*, 485 U.S. at 245–47.

61. *Id.* at 246–47.

62. *Id.* at 248–49.

63. 836 F.2d 818 (3d Cir. 1988).

64. *Id.* at 821–23.

65. *Id.* at 819–20.

Stamps v. Manor Drug Stores,⁶⁶ which limited the class of potential plaintiffs under section 10(b) to those who actually purchased or sold securities,⁶⁷ the court found that Zlotnick did both: he sold shares short and purchased shares later to cover those short sales.⁶⁸ That the sale occurred before the purchase did not affect the court's consideration of each separate transaction for the possible effects of fraud.⁶⁹ But while allowing Zlotnick the opportunity to prove his reliance, the court declined to presume it since Zlotnick believed the market price of Technicom's stock was overvalued.⁷⁰ Given Zlotnick's belief that the market in Technicom stock did not reflect all available information, the court did not find it logical to presume that the market did reflect all available information when he made his covering purchases, or that it was reasonable for Zlotnick to rely on the market price at the time of his purchase.⁷¹

While the Supreme Court in *Basic* afforded purchasers of securities a presumption of reliance,⁷² federal courts in the wake of *Zlotnick* have differed on whether a short seller's belief in overvaluation prevents the short seller from benefiting from the fraud-on-the-market presumption of reliance.⁷³ Many scholars have criticized *Zlotnick's* denial of this presumption to short sellers because it denies protection to informed investors—the very class of traders that ensure the integrity of the market.⁷⁴

66. 421 U.S. 723 (1975).

67. *See id.* at 749.

68. *Zlotnick*, 836 F.2d at 821.

69. *Id.*

70. *Id.* at 822.

71. *Id.* at 823.

72. *See supra* notes 56–62 and accompanying text.

73. *See* Douglas A. Smith, *Fraud on the Market: Short Sellers' Reliance on Market Price Integrity*, 47 WM. & MARY L. REV. 1003, 1034 n.140 (2005). For federal district court decisions holding or suggesting that short sellers cannot benefit from the presumption, see *In re PolyMedica Corp. Sec. Litig.*, 224 F.R.D. 27, 44 (D. Mass. 2004), *vacated*, 432 F.3d 1 (1st Cir. 2005); *In re Terayon Commc'ns Sys., Inc. Sec. Litig.*, No. C 00-01967 MHP, 2004 WL 413277, at *7-8 (N.D. Cal. Feb. 23, 2004); *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267, 296 (S.D.N.Y. 2003); *In re Critical Path, Inc. Sec. Litig.*, 156 F. Supp. 2d 1102, 1110 (N.D. Cal. 2001); *Weikel v. Tower Semiconductor Ltd.*, 183 F.R.D. 377, 392 (D.N.J. 1998); *Ganesh, L.L.C. v. Computer Learning Ctrs., Inc.*, 183 F.R.D. 487, 491 (E.D. Va. 1998). For federal district court decisions holding or suggesting that short sellers can benefit from the presumption, see *In re Initial Pub. Offering Sec. Litig.*, 227 F.R.D. 65, 109 (S.D.N.Y. 2004), *vacated*, 471 F.3d 24 (2d Cir. 1006); *Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.*, 315 F. Supp. 2d 666, 676 (E.D. Pa. 2004); *In re Sunbeam Sec. Litig.*, No. 98-8258-CIV, 2001 WL 899658, at *1 (S.D. Fla. July 3, 2001); *Danis v. USN Commc'ns, Inc.*, 189 F.R.D. 391, 396–97 (N.D. Ill. 1999); *Moskowitz v. Lopp*, 128 F.R.D. 624, 631 (E.D. Pa. 1989); *Fausett v. Am. Res. Mgmt. Corp.*, 542 F. Supp. 1234, 1238–39 (D. Utah 1982).

74. *See, e.g.*, Nicholas L. Georgakopoulos, *Frauds, Markets, and Fraud-on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud*, 49 U. MIAMI L. REV. 671, 721–22 (1995) (“The result of this reasoning . . . is awkward. If investors trade because they think a price is attractive, they deny faith in accurate pricing and waive use of the presumption of reliance, according to the *Zlotnick* court. Market participants who correct market inefficiency are deprived of the benefit of a legal rule based on market efficiency. In essence, *Zlotnick* allows manipulators such as TIE Communications to outwit those who are aware of the manipulation.”); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Litigation*, 55 DUKE L.J. 711, 715 (2006)

Some have argued that although a short seller believes that a security is overpriced, the decision to sell does not demonstrate that the seller deems the market ineffective; on the contrary, a short seller must rely on the effectiveness of the market, because the profitability of selling short is premised on the belief that the price would eventually revert to value.⁷⁵ Others have suggested that—rather than interpreting *Zlotnick* as preventing the presumption from arising because allowing a plaintiff short seller to prove the presumption's predicate facts would be illogical given a short seller's investment strategy—it can be interpreted as a defendant being able to rebut the presumption because of the mere fact that the plaintiff was a short seller who believed the security price to be overvalued.⁷⁶

At any rate, the fraud-on-the-market presumption for purchasers of securities and for short sellers in at least some jurisdictions avoids the evidentiary difficulties of showing reliance and, as a by-product, greatly expands the size of the class.⁷⁷ Once the presumption is in play, the potential damages available under Rule 10b-5 become enormous as every investor who purchased during the time that a misrepresentation affected the company's stock price, and did not sell it before the truth was revealed, has a cause of action and potential remedies under Rule 10b-5.⁷⁸ Moreover, a phenomenon that crops up with the presence of short selling is the apparent increase in the number of shares of stock beneficially held by investors over and above the actual number of shares issued by the corporation.⁷⁹ In the case of a Rule 10b-5 action, this apparent expansion of the beneficial ownership has real consequences since it multiplies the number of investors who are potential claimants in a suit and correspondingly multiplies the potential damages.⁸⁰

(contending that information traders are the group that can best underwrite efficient and liquid capital markets, and, hence, it is this group that securities regulation should strive to protect).

75. See Goshen & Parchomovsky, *supra* note 74, at 769 (asserting that a careful reading of the majority's opinion in *Basic* reveals that this is the correct interpretation); see also Langevoort, *supra* note 33, at 889–903.

76. See Smith, *supra* note 73, at 1015–16.

77. See Pritchard, *supra* note 59, at 221.

78. See *id.*

79. See Robert C. Apfel et al., Short Sales, Damages, and Class Certification in 10b-5 Actions 5–8 (July 2001) (unpublished paper), available at <http://schwert.ssb.rochester.edu/short0110.pdf>. A short seller borrows a share from one person and sells this share to another person. *Id.* at 6. The one who lent it to the short seller and the one who bought it from the short seller, however, cannot own the same share simultaneously. *Id.* The buyer becomes the true owner of record while the lender is not an owner of record, as long as his share is lent out. *Id.* While the lender is no longer a shareholder of record, he has a beneficial interest in a share of stock—an interest that has been created by the short seller's promise to return a share and to make up for any cash distributions paid by the company in the interim. *Id.* at 7. In this sense, the lender owns an “artificial” share created by the short seller, and the short sale has thus resulted in an apparent expansion of the beneficial ownership of the company's shares. *Id.* at 7–8. Naked short selling can even further inflate the apparent number of shares held by investors. See Christian, Shapiro & Whalen, *supra* note 28, at 1045–46.

80. See Apfel et al., *supra* note 79, at 8; see also Ganesh, L.L.C. v. Computer Learning Ctrs., Inc., 183 F.R.D. 487 (E.D. Va. 1998).

2. A Bridge to Nowhere: *Stoneridge* and the Blurred Origins of Rule 10b-5

Apart from the sweeping implications that a finding of reliance naturally manifests on damages, the opposing opinions in the Supreme Court's recent decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*,⁸¹ addressing reliance on secondary actors,⁸² allude to a deeper uncertainty at the heart of the damages controversy. *Stoneridge* filed suit against Scientific-Atlanta and other defendants under section 10(b) and Rule 10b-5 alleging losses after purchasing Charter Communications stock.⁸³ Acting as Charter's customers and suppliers, the defendants agreed to arrangements that allowed Charter to mislead its auditor and issue misleading financial statements affecting its stock price, but had no role in preparing or disseminating the financial statements.⁸⁴ The U.S. Court of Appeals for the Eighth Circuit found that the allegations did not show that the defendants made misstatements relied upon by the public or violated a duty to disclose.⁸⁵ At most, the defendants had aided and abetted Charter's misstatement, but the private cause of action implied in section 10(b) and Rule 10b-5 did not extend to aiding and abetting.⁸⁶

The majority opinion, authored by Justice Anthony Kennedy, agreed that the section 10(b) private right of action did not "reach" the defendants because Charter investors did not rely on their statements or representations.⁸⁷ The majority held that the section 10(b) private right of action does not extend to aiders and abettors, and, since a secondary actor must therefore satisfy each of the elements for section 10(b) liability, the plaintiff must prove reliance upon a material misrepresentation or omission by the defendant.⁸⁸ The Court only recognized a rebuttable presumption of reliance, however, in two circumstances: when there is an omission of a material fact by one with a duty to disclose, or, under the fraud-on-the-market theory, when the statements at issue become public.⁸⁹ Neither presumption applied here, since the defendants had no duty to disclose and their deceptive acts were not communicated to the investing public during the relevant times.⁹⁰ As a result, *Stoneridge* had not shown reliance upon any of the defendants' actions "except in an indirect chain that [is] too remote for liability."⁹¹

81. 128 S. Ct. 761 (2008).

82. *Id.* at 766.

83. *Id.*

84. *Id.* at 767.

85. *Id.*

86. *Id.*

87. *Id.* at 766.

88. *Id.* at 769.

89. *Id.*

90. *Id.*

91. *Id.* The Court also rejected *Stoneridge*'s reference to so-called "scheme liability" since it did not, absent a public statement, answer the objection that *Stoneridge* did not in fact rely upon the defendants' deceptive conduct. *Id.* at 770–71.

Justice Kennedy also brushed aside the notion that, if this were a common-law action for fraud, there could be a finding of reliance.⁹² Even if this assumption were correct, Justice Kennedy noted, it was not controlling because “Section 10(b) does not incorporate common-law fraud into federal law.”⁹³ The majority looked to the history of the section 10(b) private right and the careful approach the Court has taken before proceeding without congressional direction as further reason to find no liability in this case.⁹⁴ Asserting that “[c]oncerns with the judicial creation of a private cause of action caution against its expansion” and that the decision to extend the cause of action is for Congress and not the Court, the majority maintained that the section 10(b) private right “should not be extended beyond its present boundaries.”⁹⁵ The majority reasoned that when the Private Securities Litigation Reform Act of 1995 (PSLRA)⁹⁶ was enacted, Congress evidently accepted the section 10(b) private cause of action “as then defined but chose to extend it no further.”⁹⁷ The majority thus found its conclusion “consistent with the narrow dimensions we must give to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.”⁹⁸

In a strong dissent refuting the majority opinion on various substantive grounds not pertinent to this Note,⁹⁹ Justice John Paul Stevens also felt compelled to “comment on the importance of the private cause of action that Congress implicitly authorized” when it enacted the Exchange Act and to rebut the majority’s “mistaken hostility” toward the section 10(b) private cause of action.¹⁰⁰ Justice Stevens recounted how, throughout the nation’s history, much of our law was developed by judges in the common-law tradition: “A basic principle animating our jurisprudence was enshrined in state constitution provisions guaranteeing, in substance, that every wrong shall have a remedy.”¹⁰¹ In light of the history of court-created remedies and specifically the history of implied causes of action under section 10(b), Justice Stevens declared that “the Court is simply wrong when it states that Congress did not impliedly authorize this private cause of action ‘when it first enacted the statute.’”¹⁰² Rather, Congress enacted section 10(b) “with

92. *Id.* at 771.

93. *Id.* (citing *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005); *SEC v. Zandford*, 535 U.S. 813, 820 (2002); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 184 (1994)).

94. *Id.* at 772.

95. *Id.* at 773 (citing *Cent. Bank*, 511 U.S. at 173; *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1102 (1991)).

96. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

97. *Stoneridge*, 128 S. Ct. at 773.

98. *Id.* at 774.

99. *See id.* at 774–79 (Stevens, J., dissenting).

100. *Id.* at 779.

101. *Id.* (internal quotation marks omitted); *see also id.* 779 n.12 (collecting state constitutions).

102. *Id.* at 781 (quoting *id.* at 774 (majority opinion)).

the understanding that federal courts respected the principle that every wrong would have a remedy,” but the majority’s decision cut back further on Congress’s intended remedy.¹⁰³

This difference of opinion in *Stoneridge* is by no means novel or limited to Rule 10b-5, as courts have historically expressed one of these two conceptions of judicial power to create private rights of action.¹⁰⁴ Implying a private right of action can be viewed conservatively as an exercise in construing the intent of the legislature, or more liberally, as a court exercising an inherent judicial power to create common-law remedies for statutory violations.¹⁰⁵ Although the Supreme Court now typically treats the implication of private rights of action as a matter of statutory construction—confining analysis to whether Congress, in enacting a particular statute, intended to authorize the private remedies sought¹⁰⁶—the Court has nevertheless continued to recognize the long-established private right of action under Rule 10b-5.¹⁰⁷ This enduring fundamental divide evidenced in *Stoneridge* about the essence of Rule 10b-5 in particular, however, revitalizes an enigma that has long challenged the Court in the realm of damages.

3. Getting to Loss: From *Randall* and Deterrence to *Dura* and Compensation

In conceptualizing the key element of “economic loss,” courts have only been afforded a rather rudimentary framework with which to work. The Exchange Act provides that “no person permitted to maintain a suit for damages . . . shall recover . . . a total amount in excess of his actual damages on account of the act complained of.”¹⁰⁸ Courts have generally applied an “out-of-pocket” measure of damages—“the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct”—in section 10(b) cases involving fraud by a seller of securities.¹⁰⁹ Other than these broad guidelines, however, neither Rule 10b-5 nor the PSLRA endorses any specific theory or methodology to quantify economic loss.¹¹⁰

On one hand, the Supreme Court has repeatedly emphasized that the securities legislation that Congress enacted for the purpose of deterring

103. *Id.* at 782.

104. See Tamar Frankel, *Implied Rights of Action*, 67 VA. L. REV. 553, 557 (1981).

105. See *id.*

106. See, e.g., *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 15–16 (1979).

107. See *supra* notes 81–103 and accompanying text.

108. 15 U.S.C. § 78bb(a) (2006).

109. *Randall v. Loftsgaarden*, 478 U.S. 647, 661–62 (1986); *Blackie v. Barrack*, 524 F.2d 891, 909 (9th Cir. 1975) (noting that out-of-pocket loss is the ordinary standard in a 10b-5 suit); see also 5 BROMBERG & LOWENFELS, *supra* note 7, §§ 8:4–8:9 (delineating alternative measures of damages to out-of-pocket loss including benefit of the bargain, disgorgement, unjust enrichment or constructive trust, consequential damages, and other measures).

110. *In re Cigna Corp. Sec. Litig.*, 459 F. Supp. 2d 338, 350 (E.D. Pa. 2006).

fraud should be construed “not technically and restrictively, but flexibly to effectuate its remedial purposes.”¹¹¹ In deciding not to reduce the plaintiff’s recovery in the amount of tax benefits received, the Supreme Court in *Randall v. Loftsgaarden*¹¹² rejected the defendants’ argument that recovery under the federal securities laws was strictly limited to the defrauded investor’s “actual damages,” and hence that anything of economic value received by the victim of fraud as a result of the investment must reduce the victim’s recovery.¹¹³ Noting that “Congress did not specify what was meant by ‘actual damages,’” the Court held that there was no “rigid requirement that every recovery . . . be limited to the net economic harm suffered by the plaintiff.”¹¹⁴ The Court elaborated,

Congress’[s] aim in enacting the [Exchange] Act was not confined solely to compensating defrauded investors. Congress intended to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions. This deterrent purpose is ill served by a too rigid insistence on limiting plaintiffs to recovery of their “net economic loss.”¹¹⁵

The Court thus found that awarding damages under the Exchange Act “clearly does more than simply make the plaintiff whole for the economic loss proximately caused by the buyer’s fraud.”¹¹⁶ In fact, the Court deemed it “more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.”¹¹⁷ The Court anticipated that the deterrent value of private rights of action will thereby “provide ‘a most effective weapon in the enforcement’ of the securities laws and are a ‘necessary supplement to Commission action.’”¹¹⁸

On the other hand, the Supreme Court has also promoted the compensatory nature of damages in securities fraud actions in finding that an inflated purchase price does not by itself constitute or proximately cause the relevant loss needed to allege and prove loss causation.¹¹⁹ In *Dura Pharmaceuticals, Inc. v. Broudo*,¹²⁰ shareholders alleged that Dura made misrepresentations about a new asthmatic spray device, leading them to

111. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (“The Court has said that the [Exchange] Act and its companion legislative enactments embrace a ‘fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.” (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963))).

112. 478 U.S. 647.

113. *Id.* at 660.

114. *Id.* at 662–63.

115. *Id.* at 664 (quoting *Salcer v. Envicon Equities Corp.*, 744 F.2d 935, 940 (2d Cir. 1984)) (citing *Affiliated Ute Citizens*, 406 U.S. at 151).

116. *Id.* at 663.

117. *Id.* (quoting *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965)).

118. *Id.* at 664 (quoting *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985), *vacated sub nom. Salcer v. Envicon Equities Corp.*, 478 U.S. 1015 (1986)).

119. *See Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 342 (2005).

120. 544 U.S. 336.

purchase Dura securities at an artificially inflated price.¹²¹ The Court noted that at the moment the transaction took place, the plaintiff suffered no loss because the inflated purchase price was offset by ownership of a share that at that instant possessed equivalent value.¹²² Moreover, the logical link between the inflated purchase price and any later economic loss was not invariably strong, since other factors may affect the price.¹²³ While the inflated purchase price suggested that the misrepresentation “touche[d] upon” a later economic loss, the Court held that “to ‘touch upon’ a loss is not to *cause* a loss.”¹²⁴ The Court reasoned that “the common law has long insisted that a plaintiff in such a case show not only that had he known the truth he would not have acted but also that he suffered actual economic loss.”¹²⁵ While recognizing that the securities statutes seek to maintain public confidence in the marketplace by deterring fraud, in part through the availability of private securities fraud actions, the Court emphasized that the statutes were not intended “to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.”¹²⁶ The Court thus found that Congress’s clear intent was to permit private securities fraud actions only where “plaintiffs adequately allege and prove the traditional elements of causation and loss.”¹²⁷

Taken together, the Supreme Court’s mixed signals in *Randall* and *Dura* may simply connote complementary objectives of deterrence and compensation. Some scholars in fact frame the appropriate measure of damages as a balancing act between general deterrence and compensation concerns.¹²⁸ Notably, basing damages on the net harm that an offender’s acts cause should, according to classical tort theory, achieve optimal deterrence.¹²⁹ This school of thought equates the objectives of

121. *Id.* at 339–40.

122. *Id.* at 342.

123. *Id.*

124. *Id.* at 343.

125. *Id.* at 343–44.

126. *Id.* at 345 (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 252 (1988) (White, J., concurring in part and dissenting in part) (“[A]llowing recovery in the face of affirmative evidence of nonreliance would effectively convert Rule 10b-5 into a scheme of investor’s insurance. There is no support in the . . . Exchange Act, the Rule, or our cases for such a result.” (citations omitted) (internal quotation marks omitted))).

127. *Id.* at 346.

128. See 3B BLOOMENTHAL & WOLFF, *supra* note 39, § 13:42 (“In general policy terms, one should be concerned with (1) the necessity of deterring practices that interfere with the concept of an informed marketplace to which all investors have appropriate access without, at the same time, discouraging the flow of information to such marketplace; (2) compensating those who have been damaged by proscribed practices without at the same time imposing such financial burdens that the proscription is counterproductive; and (3) avoiding compensating one group of investors at the expense of other equally innocent investors.”).

129. See Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 651–52 (1985). *But see* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1500 (1996) (“The present

compensation and deterrence under Rule 10b-5, in that an optimal model of damages deters misconduct by forcing defendants to pay for the harm they cause.¹³⁰ As Frank Easterbrook and Daniel Fischel roundly put it, “True, people sometimes say that the function of securities law is ‘the protection of investors’ or ‘compensation for wrongs,’ but these are just restatements of the objective of efficient operation of the markets.”¹³¹

More pervasive, nonetheless, is the conviction that Rule 10b-5 is in fact—or at least should be—steered by a single overriding objective. While private rights of action under Rule 10b-5 have traditionally been rationalized on compensatory grounds,¹³² a deterrence-based justification has taken on increased prominence.¹³³ Even though truly compensatory private actions might promote the goal of deterrence, many scholars have argued that the Rule 10b-5 action does not provide meaningful compensation for investors.¹³⁴ Noting this realistic inefficacy, many scholars have instead proposed a range of damages measures founded on the deterrence objective.¹³⁵ All told, as a consequence of the varying significance attributed to the objectives of deterrence and compensation, courts calculating damages in Rule 10b-5 actions have markedly diverged—especially in cases where these objectives appear to collide.¹³⁶

D. *The Gains and Losses Problem*

Applying the “out-of-pocket” measure of damages can prove difficult when an investor has bought and sold shares numerous times during the class period.¹³⁷ The class period “is generally the period of time during

measure of class-based compensatory damages . . . is not well-supported by the traditional deterrence rationale for compensatory damages in tort law.”)

130. See Dane A. Holbrook, *Measuring and Limiting Recovery Under Rule 10b-5: Optimizing Loss Causation and Damages in Securities Fraud Litigation*, 39 TEX. J. BUS. L. 215, 249 (2003) (“Potential Rule 10b-5 violators can be induced to make correct decisions . . . where that judgment is an accurate measure of the harm they have caused. Therefore, courts should apply a predictable damage measure . . . that adequately compensates for harm to investors resulting from the defendant’s representational misconduct.”).

131. Easterbrook & Fischel, *supra* note 129, at 613.

132. See 26 KAUFMAN, *supra* note 4, § 9:13 (contending that “the major thrust of Rule 10b-5 must be compensatory”).

133. See Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between the Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1314 (2008).

134. See *id.* at 1325.

135. See, e.g., Alexander, *supra* note 129, at 1508; Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 380 (2007); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1547 (2006); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 652 (1996); A. C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 945–47 (1999).

136. See *infra* Part I.D.

137. RAYMUND WONG, NERA ECON. CONSULTING, PURCHASE-SALE MATCHING IN SECURITIES LITIGATION: FIFO, LIFO, AND OFFSETS 3 (2008), available at http://www.nera.com/image/PUB_Purchase_Sale_Matching_Wong_1008.pdf.

which plaintiffs allege that the stock price of the defendant corporation was inflated due to fraudulent statements made by company management, and ends when corrective statements are made (usually accompanied by a drop in price).¹³⁸ Applying the out-of-pocket rule is fairly straightforward when an investor purchases and sells the same number of shares in only two transactions or even when there are multiple purchases or sales, but all generate either gains or losses.¹³⁹ According to the out-of-pocket rule, the investor's damages are equal to the "difference between what [he] paid to purchase securities and how much [he] received when he sold those securities."¹⁴⁰ Analogously, out-of-pocket damages from a short sale equal the difference between the amount for which an investor sold shares short and the amount spent to repurchase the covering shares.¹⁴¹ Greater difficulty arises, however, when some purchases or sales generate a gain and some generate a loss: while everyone agrees that a Rule 10b-5 claim does not lie when there is no loss, the question is how we should determine when there is a loss.¹⁴²

In such cases, some courts have endorsed a netting approach that offsets gains and losses stemming from different transactions, while others have adopted a transactional approach that considers each transaction individually and allows the plaintiff to recover all losses without any offset for gains.¹⁴³ On the surface, choosing between the two approaches may turn on whether the Rule 10b-5 action is analyzed from the perspective of the investor as a whole or from each individual investment transaction. The netting approach arguably coincides with the Exchange Act which provides that no "person" shall recover a total amount in excess of "his" actual damages on account of the act complained of, referring to damages with respect to the investor as a whole.¹⁴⁴ The transactional approach, however, may be more consistent with section 10(b) and Rule 10b-5, which prohibit certain acts in connection with the "purchase or sale of any security," evidently bestowing a separate claim upon each individual investment transaction.¹⁴⁵

Apart from these overall damages approaches, courts at different stages in a Rule 10b-5 action also face the related but separate question of how to

138. *In re Cigna Corp. Sec. Litig.*, 459 F. Supp. 2d 338, 339 n.1 (E.D. Pa. 2006).

139. *Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.*, 315 F. Supp. 2d 666, 679 (E.D. Pa. 2004).

140. *Id.* This commonly accepted view of the out-of-pocket measure of damages, which looks at the difference between what the investor actually paid and received, technically differs from the traditional understanding articulated in *Randall v. Loftsgaarden*, 478 U.S. 647, 661–62 (1986), which looks at the difference between what the investor received and what he would have received. *See supra* note 109 and accompanying text.

141. *Argent*, 315 F. Supp. 2d at 679.

142. *Id.*

143. *See Rocker Mgmt., LLC v. Lernout & Hauspie Speech Prods., N.V.*, No. 00-5965, 2007 WL 2814653, at *14 (D.N.J. Sept. 24, 2007).

144. *See* 15 U.S.C. § 78bb(a) (2006); *see also supra* note 108 and accompanying text.

145. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (2008); *see also supra* notes 44–45 and accompanying text.

match individual transactions,¹⁴⁶ usually choosing between two distinct accounting methods: “first-in, first-out” (FIFO) and “last-in, first-out” (LIFO).¹⁴⁷ This is necessary because a single transaction is neither profitable nor unprofitable by itself; only when one transaction (purchase or short sale) is matched with a corresponding transaction (sale or cover to purchase) can the investor realize a gain or loss.¹⁴⁸ The FIFO method “assumes that goods are sold in the order in which they were purchased—that is, the oldest items are sold first,”¹⁴⁹ whereas the LIFO method “assumes that the most recent purchases are sold or used first, matching current costs against current revenues.”¹⁵⁰ In the context of Rule 10b-5 actions, FIFO and LIFO are similarly used to match purchases and sales of securities during the class period to measure a class member’s damages.¹⁵¹ Under FIFO, shares sold during the class period are matched with the first shares held or purchased at the beginning of the class period, whichever

146. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 749 (codified in scattered sections of 15 U.S.C.) (“[T]he award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.”).

147. See *In re eSpeed, Inc. Sec. Litig.*, 232 F.R.D. 95, 100 (S.D.N.Y. 2005); see also ROGER H. HERMANSON, JAMES DON EDWARDS & MICHAEL W. MAHER, ACCOUNTING PRINCIPLES: A BUSINESS PERSPECTIVE 262-68 (Freelead Press, 8th ed. 2005) (1980). Accountants have developed four inventory methods to solve valuation problems: (1) specific identification, which “attaches the actual cost to an identifiable unit of product”; (2) first-in, first-out (FIFO), which “assumes that the costs of the first goods purchased are those charged to costs of goods sold”; (3) last-in, first-out (LIFO), which “assumes that the costs of the most recent purchases are the first costs charged to cost of goods sold”; and (4) weighted-average, which is “a means of costing ending inventory using a weighted-average unit cost.” *Id.*; see also STEVEN M. BRAGG, INVENTORY ACCOUNTING: A COMPREHENSIVE GUIDE 109–21 (2005).

148. See *Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.*, 315 F. Supp. 2d 666, 680 n.18 (E.D. Pa. 2004). Matching purchases and sales of securities is necessary according to *Argent*’s understanding of the out-of-pocket measure of damages, but a single transaction at an artificially inflated price can technically be unprofitable by itself according to the traditional understanding which looks at what the investor would have received. See *supra* notes 109, 140 and accompanying text.

149. See BLACK’S LAW DICTIONARY 667 (8th ed. 2004). Advantages of using FIFO include the following: (1) it is easier to apply; (2) the assumed flow of costs often corresponds with the normal physical flow of goods; (3) no manipulation of income is possible; and (4) the balance sheet amount for inventory is likely to approximate the current market value. See HERMANSON, EDWARDS & MAHER, *supra* note 147, at 272–73, 284. Disadvantages of FIFO include the following: (1) it recognizes paper profits; and (2) the tax burden is heavier if used for tax purposes when prices are rising. See *id.*

150. See BLACK’S LAW DICTIONARY 898 (8th ed. 2004). Advantages of using LIFO include the following: (1) it reports both sales revenue and cost of goods sold in current dollars; and (2) lower income taxes result if used for tax purposes when prices are rising. See HERMANSON, EDWARDS & MAHER, *supra* note 147, at 272–73, 284. Disadvantages of LIFO include the following: (1) it often matches the cost of goods not sold against revenues; (2) it grossly understates inventory; and (3) it permits income manipulation. See *id.*

151. See *In re AOL Time Warner, Inc.*, No. MDL 1500, 02 Civ. 5575(SWK), 2006 WL 903236, at *17 (S.D.N.Y. Apr. 6, 2006); see also Sucharow & Keller, *supra* note 19, at 12–13.

comes first, whereas, under LIFO, the shares sold during the class period are matched with the most recent shares purchased.¹⁵²

Notwithstanding the variety of plausible justifications for choosing a particular damages approach or accounting method, federal courts encountering the problem of gains and losses have seemingly split in line with a rather simplistic progression stemming from the unsettled origins and objectives of Rule 10b-5. Courts that take the *Stoneridge* majority's view of the narrow statutory basis of Rule 10b-5, and thus *Randall*'s emphasis on deterrence, tend to favor the transactional approach and FIFO method, which usually curtail the offsetting of losses by gains.¹⁵³ These courts assume that penalizing violators regardless of the actual harm inflicted on investors will provide the appropriate level of deterrence.¹⁵⁴ In contrast, courts that share the *Stoneridge* dissent's view of the common law roots of the Rule 10b-5 private right of action, and hence *Dura*'s focus on compensation, tend to favor the netting approach and LIFO method, which generally foster the offsetting of losses by gains.¹⁵⁵ These courts maintain that investors are only entitled to recover their net harm suffered regardless of the gravity of the wrongdoer's actions.¹⁵⁶ While courts traveling down either path have a justifiable leg to stand on, it is not as clear how or why they discount the competing considerations.

II. FLIPPING A COIN

Two opposing views of damages under Rule 10b-5 have evidently emerged in cases involving gains and losses. Part I traced the positions these two sides have staked to their differing outlooks, epitomized by some seminal Supreme Court opinions, on the origins and objectives of Rule 10b-5.¹⁵⁷ Stemming from this fundamental discord, this part explores the opposing damages approaches and accounting methods that federal courts have chosen and their justifications for doing so. With respect to offsetting losses by gains, most courts have straight-out adopted either the netting or transactional approach, although courts in the Third Circuit have recently decided this issue on a case-by-case basis.¹⁵⁸ Similarly, as to matching purchases and sales of securities, many courts have steadfastly endorsed either FIFO or LIFO, but these decisions have not contemplated evolving principles and standards in the accounting world.¹⁵⁹

152. See *Thompson v. Shaw Group, Inc.*, No. Civ.A.04-1685, 2004 WL 2988503, at *4 (E.D. La. Dec. 14, 2004).

153. See *infra* Part II.A.2, B.1.

154. See *infra* Part II.A.2, B.1.

155. See *infra* Part II.A.1, B.2.

156. See *infra* Part II.A.1, B.2.

157. See *supra* Part I.C.

158. See *infra* Part II.A.

159. See *infra* Part II.B.

A. *Damages Approaches*

Damages calculations in Rule 10b-5 actions depend on the timing of an investor's purchases and sales at inflated prices during the class period.¹⁶⁰ Suppose a company's stock initially trading at \$10 per share were inflated to \$15 by management's fraudulent statements in 2006, reached a high of \$20 in 2007, and thereafter plunged to \$5 in 2008 upon the release of corrective statements. Shares purchased at the beginning of the class period in 2006 and sold at the peak in 2007 produce a gain, while shares purchased in 2007 and sold after corrective statements were made in 2008 produce a loss. Conversely, shares sold short in 2006 and purchased to cover at the peak in 2007 produce a loss, while shares sold short in 2007 and purchased to cover after corrective statements were made in 2008 produce a gain. Courts confronted with investors that have generated gains and losses by purchasing, selling, selling short, or purchasing to cover shares in the company at different times before, during, and after the class period must therefore decide whether to offset these gains and losses stemming from different transactions or to allow the investor to recover all losses without any offset for gains.

1. The Netting Approach

The U.S. Courts of Appeals for the Second, Fifth, Ninth, and Tenth Circuits have traditionally taken the netting approach that offsets gains and losses stemming from different transactions.¹⁶¹ Emphasizing the compensation objective of Rule 10b-5, these courts found that the Exchange Act allows plaintiffs to be made whole, but it does not entitle them to undue windfalls that exceed their net losses.¹⁶² In viewing Rule 10b-5 actions from the perspective of the plaintiff as a whole, these courts have also noted the injustice in allowing investors to count losses but ignore gains that emanate from the same misrepresentations.¹⁶³

In *Richardson v. MacArthur*,¹⁶⁴ an insurance company's employee offering stock on a subscription basis told a shareholder that he fulfilled all of his obligations in a transaction and would receive the shares of stock, when in fact, the employee completed the obligation on the transaction and took possession of the stock for himself.¹⁶⁵ In analyzing the question of damages, the Tenth Circuit stated,

160. See WONG, *supra* note 137, at 3.

161. See *Abrahamson v. Fleschner*, 568 F.2d 862, 878–79 (2d Cir. 1977); *Blackie v. Barrack*, 524 F.2d 891, 908–11 (9th Cir. 1975); *Wolf v. Frank*, 477 F.2d 467, 478–79 (5th Cir. 1973); *Richardson v. MacArthur*, 451 F.2d 35, 43–44 (10th Cir. 1971); see also *infra* notes 164–84 and accompanying text.

162. See *Richardson*, 451 F.2d at 43–44; see also *infra* notes 164–68 and accompanying text.

163. See *Abrahamson*, 568 F.2d at 878; see also *infra* notes 179–84 and accompanying text.

164. 451 F.2d 35.

165. *Id.* at 37–39.

[I]t is a well recognized rule that the complaining party is entitled to be made whole. That is, he is entitled to be compensated only to the extent that he received less than what he was entitled to under the agreement. He cannot, however, recover in excess of that to which he was entitled in making him whole.¹⁶⁶

The court found that the plaintiff actually realized a profit on his sale and that the profit should be included in reducing his damages, reasoning that he “should not be allowed to retain this profit in silence while pleading to be made whole for his losses.”¹⁶⁷ Rather than giving the plaintiff an “undue windfall,” the court held that his total losses should be “reduced by any dividends, profits, or other payments actually received in transactions involving the stock, together with the settlement of claims against the purchaser by which he [was] benefited.”¹⁶⁸

Similarly, shareholders of a bank holding company in *Wolf v. Frank*¹⁶⁹ claimed that their equity interest was diluted by the company’s failure to fulfill its promise—not to allow more than a certain number of people to purchase shares before the company’s initial public offering—that induced the shareholders to purchase stock.¹⁷⁰ Given, however, that the district court granted shareholders the option to rescind the purchase of their remaining shares, that the shareholders made a profit on their original purchase of the stock, and that “Rule 10b-5 only provides for recovery of actual damages . . . and not for loss of speculative profits,” the Fifth Circuit concluded that the “plaintiffs [were] unable to show that they suffered any damages compensable under Rule 10b-5.”¹⁷¹

The question of damages also often arises in class actions when defendants contend that the interests of class members in proving damages from price inflation irreconcilably conflict because some class members will desire to maximize the inflation existing on a given date while others will desire to minimize it.¹⁷² The Ninth Circuit in *Blackie v. Barrack*¹⁷³ conceded that class members might ultimately have differing interests, but determined that such potential conflicts do not invalidate class certification.¹⁷⁴ The court noted that under the out-of-pocket standard, each purchaser recovers the difference between the inflated price paid and the value received, plus interest on the difference.¹⁷⁵ If the stock was resold at an inflated price, the investor’s damages, limited to “actual damages,” must be diminished by the inflation he recovered from his purchase.¹⁷⁶ Each

166. *Id.* at 43.

167. *Id.* at 44.

168. *Id.*

169. 477 F.2d 467 (5th Cir. 1973).

170. *Id.* at 471–72.

171. *Id.* at 478–79.

172. *See Blackie v. Barrack*, 524 F.2d 891, 908 (9th Cir. 1975).

173. 524 F.2d 891.

174. *Id.* at 908–11.

175. *Id.* at 908.

176. *Id.* at 908–09.

investor is therefore interested in proving that some intervening event diminished the inflation persisting in the stock price when he sold.¹⁷⁷ Despite this unavoidable conflict resulting from offsetting losses by gains, the court held that any conflict was peripheral and substantially outweighed by the class members' overriding common interest in establishing the existence and materiality of misrepresentations.¹⁷⁸

Finally, in *Abrahamson v. Fleschner*,¹⁷⁹ limited partners in an investment partnership claimed that the general partners misreported the partnership's investments in unregistered securities.¹⁸⁰ The Second Circuit disagreed with the lower court's blanket finding that "since plaintiffs realized a net profit on their overall limited partnership investment, they failed to prove damages compensable under [Rule 10b-5]."¹⁸¹ This was not to say, however, "that a plaintiff may recover for losses, but ignore his profits, where both result from a *single* wrong."¹⁸² The court therefore concluded that "[t]he proper measure of damages . . . would be that part of net losses incurred on unregistered securities after the point when the defendants' representations became fraudulent[,] which stems from the portion of those investments inconsistent with defendants' representations."¹⁸³ As the Second Circuit clarified a few days later, "For damages purposes under the Exchange Act, the transaction cannot be fractionated, since otherwise 'actual damages on account of the act complained of' would be exceeded."¹⁸⁴

In short, courts regarding compensation as the primary objective under Rule 10b-5 and viewing damages from the perspective of the investor as a whole have taken a netting approach that offsets gains and losses stemming from different transactions.

177. *Id.* at 909–10.

178. *Id.*; *see also* *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1436–37 (9th Cir. 1987); *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1344–46 (9th Cir. 1976) (Sneed, J., concurring). *But see* *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Sys.*, No. C 01-20418 JW, 2004 U.S. Dist. LEXIS 27008, at *10–11 (N.D. Cal. May 27, 2004) (holding that "every time Plaintiffs purchased stock at an allegedly inflated price during the Class Period, they were arguably injured at the moment of the purchase, notwithstanding earlier or later sales").

179. 568 F.2d 862 (2d Cir. 1977).

180. *Id.* at 866–67.

181. *Id.* at 878.

182. *Id.*

183. *Id.* at 879. *But see In re Blech Sec. Litig.*, 94 Civ. 7696 (RWS), 2003 U.S. Dist. LEXIS 4650, at *73 (S.D.N.Y. Mar. 26, 2003); *In re Crazy Eddie Sec. Litig.*, 948 F. Supp. 1154, 1172 (E.D.N.Y. 1996) ("While such an off-set may be appropriate for purposes of sentencing in a criminal case, [the defendant] presents no reason why he is entitled to this off-set here, let alone why a perpetrator of securities fraud would generally have any off-set against the class merely because there were some purchasers fortunate enough not to have been injured.").

184. *See* *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1314 (2d Cir. 1977) (quoting 15 U.S.C. § 78bb(a) (2006)) (citing *Abrahamson v. Fleschner*, 392 F. Supp. 740, 746–47 (S.D.N.Y. 1975)).

2. The Transactional Approach

Despite these leading circuit court decisions adopting the netting approach, a number of courts have more recently taken a transactional approach that considers each transaction individually and allows the plaintiff to recover all losses without any offset for gains. While not entirely abandoning the netting approach, some courts in the abovementioned circuits have distinguished those earlier rulings as applying only to the commission of a single wrong or to the execution of a single transaction.¹⁸⁵ Moreover, several district courts in other circuits have outright rejected the aggregation of damages, finding that it undermines the deterrence objective of the federal securities laws¹⁸⁶ and deviates from the language of the statutes that appear to treat every transaction as a separate claim for damages.¹⁸⁷

Although the Ninth Circuit had already adopted the netting approach,¹⁸⁸ the court later distinguished the particular fraud of “churning,” in which a broker executes excessive transactions to generate fees, since it involves two separate wrongs.¹⁸⁹ In *Nesbit v. McNeil*,¹⁹⁰ the defendants argued that the plaintiffs should not recover damages for churning where there was an increase in portfolio values that exceeded the amount of commissions charged.¹⁹¹ The court explained, however, that churning causes two separate and distinct possible harms: first, the investor is harmed by having paid the excessive commissions to the broker, and second, the investor is harmed by the diminished value of his portfolio caused by the broker’s having executed transactions to generate fees that were unsuitable for the investor.¹⁹² Even though the plaintiffs only suffered one of those harms, the court found no reason that they should be denied a recovery when their portfolio increased in value, either because of or in spite of the defendants’ activities.¹⁹³ The court held that a plaintiff may recover separately either or both types of damages and that “gains in portfolio will not offset losses in commissions.”¹⁹⁴ Not to be misconstrued, though, the court clarified that it was not overturning its use of the netting approach in prior cases where “the issue was portfolio loss, and, of course, dividends gained on the portfolio

185. See *Nesbit v. McNeil*, 896 F.2d 380, 385–87 (9th Cir. 1990); *In re Clinton Oil Co. Sec. Litig.*, M.D.L. No. 137, 1977 U.S. Dist. LEXIS 16787, at *3 (D. Kan. Mar. 22, 1977); see also *infra* notes 188–203 and accompanying text.

186. See *Kane v. Shearson Loeb Rhoades, Inc.*, No. 86-551-CIV-MARCUS, 1989 U.S. Dist. LEXIS 19022, at *23 (S.D. Fla. May 3, 1989); see also *infra* notes 204–10 and accompanying text.

187. See *Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.*, 315 F. Supp. 2d 666, 680 (E.D. Pa. 2004); see also *infra* notes 211–17 and accompanying text.

188. See *Blackie v. Barrack*, 524 F.2d 891, 908–10 (9th Cir. 1975); see also *supra* notes 172–78 and accompanying text.

189. See *Nesbit*, 896 F.2d at 385–87.

190. 896 F.2d 380.

191. *Id.* at 385.

192. *Id.*

193. *Id.*

194. *Id.* at 386.

were properly considered in that context.”¹⁹⁵ In this case, however, the loss arose out of commissions on trades that never should have taken place regardless of whether the portfolio value went up, went down, or stayed the same.¹⁹⁶ That, according to the court, was “a separate wrong for which damages are separately recoverable.”¹⁹⁷

Similarly, at least one district court limited the Tenth Circuit’s earlier adoption of the netting approach¹⁹⁸ to cases involving gains and losses from a single transaction. In *In re Clinton Oil Co. Securities Litigation*,¹⁹⁹ court representatives disallowed many claims on a settlement fund on the grounds that those claimants had not suffered any actual damages since they realized a net profit on sales of the stock when aggregate gains and losses were offset.²⁰⁰ The court noted that *Richardson* offset net losses and profits realized on sales of stock purchased in a single transaction, but distinguished this case, in which claimants acquired their stock in multiple purchase transactions and sold it at different times.²⁰¹ “Under the *Richardson* rule, offsetting net losses and profits realized on the sale of stock acquired in a single purchase transaction would be warranted, but the case says nothing about the multiple purchase transaction situation.”²⁰² Taking the transactional approach instead, the court ruled that “[n]et profits and losses realized on sales of stock acquired in a single purchase transaction should be offset, but profit/loss margins on sales of shares obtained in separate and independent purchase transactions should not be offset for the purpose of reaching a net figure.”²⁰³

Where circuit courts had not yet ruled on the issue, some district courts have stressed the deterrence objective of the Exchange Act in taking the transactional approach. In *Kane v. Shearson Loeb Rhoades, Inc.*,²⁰⁴ the plaintiffs claimed that an arbitration panel erred in reducing their losses on one transaction by the gains realized on a separate transaction, and that the proper damages approach under both state and federal securities laws was to treat each transaction separately.²⁰⁵ The U.S. District Court for the Southern District of Florida agreed that “[s]uch an aggregation method for the calculation of out of pocket damages in a securities action undermines

195. *Id.* at 386 n.6.

196. *Id.*

197. *Id.*; see also *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1217–19 (8th Cir. 1990) (holding that churning is not excused by the fact that the account realizes a net profit, because otherwise, “securities brokers would be free to churn their customers’ accounts with impunity so long as the net value of the account did not fall below the amount originally invested”).

198. See *Richardson v. MacArthur*, 451 F.2d 35, 43–44 (10th Cir. 1971); see also *supra* notes 164–68 and accompanying text.

199. M.D.L. No. 137, 1977 U.S. Dist. LEXIS 16787 (D. Kan. Mar. 22, 1977).

200. *Id.* at *1.

201. *Id.* at *3.

202. *Id.*

203. *Id.* at *5.

204. No. 86-551-CIV-MARCUS, 1989 U.S. Dist. LEXIS 19022 (S.D. Fla. May 3, 1989).

205. *Id.* at *15.

one of the principal goals of both federal and state securities laws: deterring fraud.”²⁰⁶ The court cited the U.S. District Court for the Eastern District of Virginia in *Merchant v. Oppenheimer & Co.*²⁰⁷ that likewise found “no reason in logic or in law why either the buyer or the seller should be required to deal with each such violation in the same manner or be required to aggregate them.”²⁰⁸ The court in *Merchant* found it difficult to characterize a fraud victim’s remedy a “windfall,” even if it exceeded total out-of-pocket loss, since “a buyer of securities [was intended] to recover damages for any sale of securities in violation of the statute, regardless of whether the buyer happened to profit from other sales of securities in violation of the statute.”²⁰⁹ The court in *Kane* also noted that if the netting approach advanced by the defendants were adopted, “it could serve as a license for broker-dealers to defraud their customers with impunity up to the point where losses equaled prior gains,” and that was clearly not intended by the drafters of either state or federal antifraud provisions.²¹⁰

Other district courts have also asserted that the transactional approach is supported by the plain language of the statutes. In *Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.*,²¹¹ arbitrageurs that invested heavily in the securities of Rite Aid sued Rite Aid, several of its former executives, and its former auditor when details of an alleged billion-dollar accounting fraud surfaced.²¹² In considering damages, the U.S. District Court for the Eastern District of Pennsylvania found the language of section 10(b) and Rule 10b-5 more consistent with a transaction-based methodology than a cumulative one:²¹³

Both provisions make it illegal for someone to make materially misleading statements “in connection with the purchase or sale of any security.” . . . By using the singular nouns “purchase” or “sale”, Congress and the SEC focus on each transaction individually. Neither the statute nor the Rule authorize any sort of aggregation of purchases or sales that could sanction the cumulative approach.²¹⁴

Argent acknowledged that a transaction-based methodology generates higher damages than a cumulative methodology because the former ignores profitable transactions and the latter includes them to offset unprofitable transactions.²¹⁵ The court reasoned, however, that “[i]f one conceptualizes every multiple-share transaction as multiple single-share transactions, then

206. *Id.* at *23.

207. 568 F. Supp. 639 (E.D. Va. 1983).

208. *Id.* at 643.

209. *Id.* at 643–44.

210. 1989 U.S. Dist. LEXIS at *23.

211. 315 F. Supp. 2d 666 (E.D. Pa. 2004).

212. *Id.* at 669.

213. *Id.* at 680.

214. *Id.* (quoting 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2008)); see also *In re Sepracor Inc. Sec. Litig.*, 233 F.R.D. 52, 54 (D. Mass. 2005).

215. *Argent*, 315 F. Supp. 2d at 681.

any apparent unfairness to defendants dissipates.”²¹⁶ Or as another court put it, “A plaintiff’s claim [should be] determined on the basis of each individual share; just as a plaintiff is not required to offset the gain realized from a contract that has not been breached by a defendant against the losses accrued from those contracts actually breached by the defendant.”²¹⁷

In short, courts regarding deterrence as the primary objective under Rule 10b-5 and viewing damages from the perspective of each individual investment transaction have taken a transactional approach that considers each transaction individually and allows the plaintiff to recover all losses without any offset for gains.

3. Third Circuit Cases

Declining to adopt one damages approach over the other, two courts in the Third Circuit have recently resolved instead to embark on a case-by-case expedition. The Eastern District of Pennsylvania led the way in *In re Cigna Corp. Securities Litigation*,²¹⁸ which dealt with alleged losses the Pennsylvania Employees Retirement System (SERS) sustained on investments in the stock of Cigna Corp.²¹⁹ SERS managed its portfolio through twenty-three external investment managers, with each manager investing the funds allocated to it and each manager’s performance measured separately.²²⁰ During the class period, SERS had positions in Cigna in six different managers’ accounts.²²¹ Some managers engaged in only long transactions, one engaged in only short selling, and others had both long and short transactions.²²² At any given time during the class period, one or more of the managers might be buying Cigna stock, selling, selling short, or purchasing to cover short sales.²²³

The opposing parties and their expert witnesses sparred about whether the shares in different accounts should be aggregated.²²⁴ Pushing the netting approach, the defendants contended that treating shares in different accounts separately was contrary to modern portfolio theory, which governed how SERS treated its own investments,²²⁵ and would also

216. *Id.*

217. *Burke v. Ruttenberg*, 102 F. Supp. 2d 1280, 1302 n.32 (N.D. Ala. 2000); *see also* 26 KAUFMAN, *supra* note 4, § 9:11 (viewing individual securities transactions as contracts, which, when breached, give rise to contract-based damages).

218. 459 F. Supp. 2d 338 (E.D. Pa. 2006).

219. *Id.* at 339. “SERS,” as abbreviated by the court, stands for “State Employee Retirement System.” *Id.*

220. *Id.* at 341.

221. *Id.*

222. *Id.*

223. *Id.*

224. *See id.* at 342–48.

225. SERS followed modern portfolio theory, which emphasizes that an investor should focus on an entire portfolio instead of any individual security theory, by employing twenty-three external investment managers in the investment management of its assets. *Id.* at 343–44. *See generally* Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721 (1976).

effectively give SERS an insurance policy for any account that registered a loss.²²⁶ Moreover, the defendants claimed that when all the transactions were aggregated, SERS incurred no economic loss because it was a net seller of Cigna stock during the class period in which the price was rising and thus actually benefited from the inflation rather than suffering a loss.²²⁷ SERS countered that the defendants' argument depended on methodologies not normally used for calculating gain or loss on a particular stock and that the defendants' offset theory has been "uniformly rejected by Courts in this District and elsewhere, has never been accepted by any court and is contrary to well-established law and the [PSLRA]."²²⁸ Citing many of the abovementioned cases,²²⁹ the court found "several decisions of record in which courts have criticized the results of a transaction-based methodology," but also "a significant amount of authority which would allow a jury to apply a transaction-based methodology, if based on adequate evidence, to calculate economic loss and damages."²³⁰ Having "fundamental concerns . . . about adopting any specific theory as a matter of law," the court held that "[t]he specific calculation of damages in this case should be resolved based on a trial record, rather than at the summary judgment stage."²³¹

On the heels of the Eastern District of Pennsylvania's decision in *In re Cigna*, the U.S. District Court for the District of New Jersey in *Rocker Management, LLC v. Lernout & Hauspie Speech Products N.V.*²³² considered claims arising from a hedge fund's short positions in a company that had allegedly committed a host of frauds and misrepresentations.²³³ Rocker initially identified the stock of Lernout & Hauspie Speech Products (L & H) as a desirable security to short based on publicly available information.²³⁴ As time went on, however, Rocker grew suspicious that L & H had engaged in related party transactions to inflate reported sales.²³⁵ While continuing to increase its short position in L & H, Rocker campaigned to expose the alleged fraud by contacting financial analysts, publishing magazine articles, and requesting an SEC investigation.²³⁶ Following an investigative report published by the *Wall Street Journal*

226. *In re Cigna*, 459 F. Supp. 2d at 347.

227. *Id.*

228. *Id.* at 348 (alteration in original) (quoting Lead Plaintiff's Memorandum in Opposition to Defendants' Motion for Summary Judgment Seeking Dismissal of SERS' Claims for Lack of Economic Loss and Loss Causation at 5, *In re Cigna*, 459 F. Supp. 2d 338 (Civil Action No. 02-8088), 2006 WL 1760141).

229. *See supra* Part II.A–B.

230. *In re Cigna*, 459 F. Supp. 2d at 351, 354.

231. *Id.* at 352, 354.

232. Civil Action No. 00-5965 (PGS), 2007 WL 2814653 (D.N.J. Sept. 24, 2007).

233. *See id.* at *1–7.

234. *Id.* at *2.

235. *Id.*

236. *Id.* at *3–6.

exposing fraudulent activities at L & H²³⁷ and the subsequent SEC investigation, L & H admitted to errors in its figures and refiled its financial statements, ultimately reversing 70% of its revenues for the previous three years.²³⁸

In determining whether Rocker suffered an economic loss, the court deliberated whether to net the gains and losses of Rocker's short sales or to consider each short sale individually and allow Rocker to recover all losses without any offset for gains.²³⁹ The court noted that "various circuits are inconsistent—some utilizing the transactional approach, and some using the netting approach," but the "Third Circuit has not squarely confronted the issue."²⁴⁰ Rather than adopting either approach as a blanket rule, the court decided that "whether the netting or transactional approach is utilized depends on the circumstances," and, "[s]ince using the netting or transactional approach is a fact-sensitive inquiry, it is best accomplished on a case-by-case basis."²⁴¹ In this instance, the court concluded that the netting approach was more appropriate because it better reflected Rocker's activities during the damage period.²⁴² Rocker had made "hundreds, if not thousands, of short transactions involving millions of shares on an ongoing basis for a period of about 30 months."²⁴³ Rocker constantly communicated with regulators, analysts, and reporters about L & H's operations and financial reporting during the period and continually adjusted its position in L & H.²⁴⁴ Given this "continuum of activity," the court held that losses should be offset by gains generated by Rocker's "ongoing trading strategy" to manage its position in L & H stock.²⁴⁵

While these cases in the Third Circuit have made significant headway in rounding up the various theories and arguments for choosing a damages approach, the courts left the contiguous accounting method question unanswered. As the expert witnesses unsurprisingly disagreed on whether to use FIFO or LIFO to match purchases and sales of securities, the court in *In re Cigna* examined the issue but found "no appellate ruling that a judge must charge a jury that one of these is proper to the exclusion of the other."²⁴⁶ Similarly, *Rocker* "left for another day" the manner in which particular short positions should be matched with covering purchases, resolving to entertain arguments from the parties as to an appropriate method should the matter go forward.²⁴⁷

237. See Mark Maremont, Jesse Eisinger & Meeyoung Song, *Tech Firm's Korean Growth Raises Eyebrows*, WALL ST. J., Aug. 8, 2000, at C1.

238. *Rocker*, 2007 WL 2814653, at *6-7.

239. *Id.* at *14.

240. *Id.*

241. *Id.*

242. *Id.* at *15.

243. *Id.*

244. *Id.*

245. *Id.*

246. *In re Cigna Corp. Sec. Litig.*, 459 F. Supp. 2d 338, 355 (E.D. Pa. 2006).

247. *Rocker*, 2007 WL 2814653, at *13 n.13.

B. Accounting Methods

Courts have identified two key differences between the FIFO and LIFO methods used to match purchases and sales of securities in Rule 10b-5 actions.²⁴⁸ Suppose an investor purchases 1000 shares of a company's stock in 2006 at \$10, purchases another 1000 shares in 2007 at \$15, and then sells 1000 shares in 2008 at \$12. At the end of 2008, corrective statements are made, and the court determines that the class period spanned all three years. Using FIFO to calculate the gain or loss on the purchase and sale of securities, the purchase price is $\$10 \times 1000 = \$10,000$, and the sale price is $\$12 \times 1000 = \$12,000$, for a gain of \$2000. Using LIFO, on the other hand, the purchase price is $\$15 \times 1000 = \$15,000$, and the sale price is $\$12 \times 1000 = \$12,000$, for a loss of \$3000. While this classic difference between FIFO and LIFO stems from the discrepancy in price between earlier and later securities purchased, another major difference emerges specifically in Rule 10b-5 actions. Suppose the price of the stock remained \$10 in 2007 and that the class period only covered 2007 and 2008. Using FIFO, the sale at an artificially inflated price in 2008 is matched with the earlier purchase in 2006, but, since that purchase predated the class period, the entire transaction resulting in a gain of \$2000 will be excluded from the damages calculation. Using LIFO, however, the sale at an artificially inflated price in 2008 is matched with the later purchase in 2007, and, since that purchase occurred during the class period, the transaction resulting in a gain of \$2000 will be included in the damages calculation.²⁴⁹ Hence, the method used may not only determine the extent of the gain or loss on a matched transaction, but also whether or not the transaction occurred during the class period and, consequently, whether to be included at all in the damages calculation.

1. The FIFO Method

The FIFO method, which matches the first shares sold with the first shares purchased, usually produces greater damages awards. Since the first shares purchased are very often preclass period purchases, the first shares sold at artificially inflated prices are matched with these preclass purchases and the likely resulting gain is excluded from the damages calculation.²⁵⁰ Only thereafter are class period sales matched with class period purchases

248. See *infra* Part II.B.1–2.

249. Given the fact-specific nature of Rule 10b-5 actions, this presumption that FIFO will exclude preclass period gains and thereby produce higher damages than LIFO is most often, although not always, the case. Clearly, no gains would be excluded where there are no preclass period purchases. Moreover, even if there are preclass period purchases, FIFO would conceivably produce lower damages where, for example, the inception of the class period saw a decline in stock price, albeit one tempered by the company's misrepresentations, so that matching preclass period purchases with sales early on in the class period would generate losses. Such exceptions notwithstanding, Parts II.B.1 and II.B.2 demonstrate that FIFO will produce higher damages in the vast majority of cases.

250. See *In re* Cardinal Health, Inc. Sec. Litig., 226 F.R.D. 298, 303 (S.D. Ohio 2005).

to calculate damages.²⁵¹ Courts using FIFO in Rule 10b-5 actions reason that a plaintiff's claim is based on losses that resulted from purchases of stock made during the class period, and, as such, any gains made on sales of shares purchased before the class period are irrelevant.²⁵² These courts also point out that the FIFO method, which the Internal Revenue Service (IRS) consistently uses,²⁵³ is a firmly established methodology for calculating loss for tax purposes in the context of securities investments.²⁵⁴

A number of district courts have used FIFO to approve the lead plaintiff in securities fraud class actions.²⁵⁵ In *In re Veeco Instruments, Inc. Securities Litigation*,²⁵⁶ the U.S. District Court for the Southern District of New York held that a pension trust was the presumptive lead plaintiff based on its investments in the corporation's securities and its financial losses under FIFO.²⁵⁷ While the pension trust admitted that it purchased shares of Veeco stock and that it sold those shares at a profit, the pension trust argued, using FIFO to match purchases and sales, that it actually lost money on its Veeco holdings.²⁵⁸ The court agreed that FIFO is the appropriate method for matching purchases and sales of securities in considering the financial stake of a movant for lead plaintiff status, "just as it is the well-settled methodology for computing losses on securities for tax purposes."²⁵⁹ The court held that if there were a fraud here, the plaintiff had a claim that it suffered a loss as a result of that fraud, and it did not find that the plaintiff had "in any way misled the court concerning its losses."²⁶⁰

251. *See id.*

252. *See In re Schering-Plough Corp. Sec. Litig.*, No. Civ.A. 01-0829, 2003 WL 25547564, at *9 (D.N.J. Oct. 10, 2003). The FIFO method is also arguably more consistent with the PSLRA's preference that institutional investors serve as lead plaintiffs, as it often favors institutional investors that typically hold large blocks of stock that were acquired prior to the alleged fraud. *See In re Cardinal Health*, 226 F.R.D. at 303.

253. The IRS permits taxpayers to use either FIFO or specific identification to match purchases and sales of securities. *See* Treas. Reg. § 1.1012-1(c) (2008); *infra* notes 295-99.

254. *See Thompson v. Shaw Group*, No. Civ.A.04-1685, 2004 WL 2988503, at *4 n.5 (E.D. La. Dec. 14, 2004) (citing *Helvering v. Campbell*, 313 U.S. 15, 20-21 (1941)).

255. *See In re Veeco Instruments, Inc. Sec. Litig.*, 233 F.R.D. 330, 333 (S.D.N.Y. 2005); *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Systems, Inc.*, No. C 01-20418 JW, 2004 U.S. Dist. LEXIS 27008, at *11 (N.D. Cal. May 27, 2004) (finding that plaintiffs sought damages consistent with the FIFO accounting method, "which has been established as a legitimate method for computing losses or gains from stock purchases or sales"); *In re Schering-Plough Corp.*, 2003 WL 25547564, at *9 (using FIFO to calculate the plaintiff's loss in connection with its purchases of Schering-Plough stock during the class period); *see also In re Chipcom Corp. Sec. Litig.*, No. CIV. A. 95-11114-DPW, 1997 WL 1102329, at *24 (D. Mass. June 26, 1997) (mandating FIFO to calculate recognized claims on a net settlement fund).

256. 233 F.R.D. 330.

257. *Id.* at 333.

258. *Id.*

259. *Id.*

260. *Id.*

Courts have reluctantly used FIFO in other instances.²⁶¹ In *Thompson v. Shaw Group, Inc.*,²⁶² plaintiffs competed for appointment of lead plaintiff and counsel in a proposed class action involving allegations of securities fraud in the purchase of Shaw Group's stock.²⁶³ For the immediate narrow purpose of considering the financial stake of movants for lead plaintiff, the U.S. District Court for the Eastern District of Louisiana resorted to the traditional FIFO method.²⁶⁴ But for ultimately deciding damages in future phases of the litigation, the Court indicated that "FIFO may be insufficiently accurate and jettisoned in favor of LIFO."²⁶⁵

So under FIFO, sales during the class period are matched with the earliest purchases to compute gains or losses on individual transactions. Since these earliest purchases were very often made before the class period, many or all gains resulting from sales during the class period at an artificially inflated price will be excluded from the damages calculation. Consequently, the prospect of offsetting losses by gains under FIFO "would appear to be largely irrelevant" as these gains are eliminated at the outset.²⁶⁶ Courts using FIFO thus align with the transactional approach and the view of deterrence as the primary objective of Rule 10b-5.

2. The LIFO Method

More recently, district courts have "generally rejected FIFO as an appropriate means of calculating losses in securities fraud cases"²⁶⁷ and instead prefer the LIFO method, which matches the first shares sold with the last shares purchased. The main advantage of LIFO is that it takes into account gains that might have accrued to plaintiffs during the class period due to the inflation of the stock price, whereas FIFO ignores many or all sales occurring during the class period and hence may exaggerate losses.²⁶⁸ Because this method contemplates the offsetting gains the parties collected

261. See *In re eSpeed, Inc. Sec. Litig.*, 232 F.R.D. 95, 101 (S.D.N.Y. 2005); see also *In re AOL Time Warner, Inc.*, No. MDL 1500, 02 Civ. 5575(SWK), 2006 WL 903236, at *18 n.25 (S.D.N.Y. Apr. 6, 2006) ("[This opinion] should not be read as an unconditional endorsement of FIFO as the method for matching purchases and sales for the calculation of damages in securities fraud litigation. Rather, the insignificance of the methodology applied in this case makes it counter-productive to require Plaintiffs to revise the Plan of Allocation and reinitiate the Notice period in order to calculate damages according to LIFO."); *In re Cardinal Health, Inc. Sec. Litig.*, 226 F.R.D. 298, 304 (S.D. Ohio 2005) (resorting to FIFO for the immediate narrow purpose of evaluating the plaintiffs, but noting that the court's use of FIFO "in no way demonstrates a modicum of approval of FIFO."); *Thompson v. Shaw Group, Inc.*, No. Civ.A.04-1685, 2004 WL 2988503, at *5 (E.D. La. Dec. 14, 2004).

262. 2004 WL 2988503.

263. *Id.* at *1.

264. *Id.* at *5.

265. *Id.*

266. See *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Systems, Inc.*, No. C 01-20418 JW, 2004 U.S. Dist. LEXIS 27008, at *11 (N.D. Cal. May 27, 2004).

267. *In re eSpeed, Inc. Sec. Litig.*, 232 F.R.D. 95, 101 (S.D.N.Y. 2005) (quoting *In re Cable & Wireless, PLC Sec. Litig.*, 217 F.R.D. 372, 378-79 (E.D. Va. 2003)).

268. See *id.*

during the class period, many courts have found that it is a better measurement of damages.²⁶⁹

Many district courts have used LIFO to approve the lead plaintiff in securities fraud class actions.²⁷⁰ Remarking that “[t]hings are not always what they seem,” the U.S. District Court for the Northern District of Illinois in *In re Comdisco Securities Litigation*²⁷¹ found one plaintiff’s claim that it suffered losses in connection with its investment in Comdisco common stock a “mirage created by [the plaintiff’s] adoption of a FIFO . . . approach to its dealings in the stock.”²⁷² The court held that when those transactions “are *properly* matched, rather than by the impermissible application of a FIFO methodology . . . [the plaintiff’s] Class Period sales at inflated prices caused it to derive unwitting benefits rather than true losses from the alleged securities fraud.”²⁷³ The court thus followed the host of cases that reject “the kind of artificial ‘loss’ that is manufactured by [the plaintiff’s] attempted FIFO construct in favor of a calculation that properly

269. *See id.* at 102.

270. *See In re Organogenesis Sec. Litig.*, 241 F.R.D. 397, 402 (D. Mass. 2007) (“Like other courts that have examined the issue, this court concludes as a matter of law that LIFO is the preferred approach for assessing class period damage.”); *Johnson v. Dana Corp.*, 236 F.R.D. 349, 353 (N.D. Ohio 2006) (“[T]o determine which party has the largest financial interest for the purposes of appointing a lead plaintiff, this court endorses the use of LIFO over FIFO.”); *In re Doral Fin. Corp. Sec. Litig.*, 414 F. Supp. 2d 398, 403 n.7 (S.D.N.Y. 2006) (“It is unclear . . . whether all of the parties calculated using [LIFO], as opposed to FIFO. The latter has fallen out of favor in this District, given its tendency to overstate the losses of institutional investors and to understate gains made from stock sold during the class period.”); *Hill v. Tribune Co.*, No. 05 C 2602, 2005 WL 3299144 at *2 (N.D. Ill. Oct. 13, 2005) (“The current majority view . . . is that securities fraud losses should be calculated using LIFO. . . . LIFO is also often used in determining the largest financial interest for purposes of the PSLRA lead plaintiff presumption.” (citation omitted)); *In re eSpeed, Inc. Sec. Litig.*, 232 F.R.D. 95, 102 (S.D.N.Y. 2005) (“Because [LIFO] contemplates the offsetting gains the parties collected during the class period, it is a better measurement of the true damages sustained by the plaintiffs.”); *In re Pfizer Inc. Sec. Litig.*, 233 F.R.D. 334, 337 n.3 (S.D.N.Y. 2005) (“It is not clear . . . whether all of the parties made their calculations using [LIFO], as opposed to FIFO. The latter has fallen out of favor in this District because of its tendency to overstate the losses of institutional investors and to understate gains made from stock sold during the class period.”); *Arenson v. Broadcom Corp.*, No. SA CV 02-301GLT, 2004 WL 3253646, at *2 (C.D. Cal. Dec. 6, 2004) (“Applying a LIFO methodology is supported by adequate authority, especially in light of the body of case law rejecting FIFO.”); *In re Goodyear Tire & Rubber Co. Sec. Litig.*, No. 5:03 CV 2166, 2004 WL 3314943, at *4 (N.D. Ohio May 12, 2004) (“FIFO grossly inflates the Institutional Funds’ damages because the Institutional Funds are a ‘net seller’ of Goodyear stock.”); *In re Cable & Wireless, PLC Sec. Litig.*, 217 F.R.D. 372, 379 (E.D. Va. 2003) (“[The plaintiff’s] loss is not as significant as alleged, because [the plaintiff] used an unaccepted method of calculating its loss.”); *In re Comdisco Sec. Litig.*, 150 F. Supp. 2d 943, 945–46 (N.D. Ill. 2001); *In re Clearly Canadian Sec. Litig.*, No. C-93-1037-VRW, 1999 WL 707737, at *4 (N.D. Cal. Sept. 3, 1999) (“[U]se of the ‘first in, first out’ method of pairing purchases and sales of shares will identify damages where in reality there may be none; the ‘FIFO’ assumption is in no way based on actual trading practices in general, let alone the trades of actual claimants.”).

271. 150 F. Supp. 2d 943.

272. *Id.* at 945.

273. *Id.*

nets out purchases and sales *during* the class period and determines gains or losses in those terms.”²⁷⁴

Courts have also used LIFO to calculate shareholders’ final damages awards in securities fraud actions.²⁷⁵ In *SEC v. Bear, Stearns & Co.*,²⁷⁶ the SEC, National Association of Securities Dealers, New York Stock Exchange, and state regulators conducted investigations of potential conflicts of interest in equity research analysis that culminated in the Global Research Analyst Settlement between the SEC and twelve financial institutions and two individuals.²⁷⁷ The distribution fund administrator’s settlement plan approved by the court mandated the use of LIFO for determining compensation amounts.²⁷⁸ The settlement plan dictated, in relevant part, that “eligible losses will be calculated on a last-in, first-out (‘LIFO’) accounting basis and will include commissions and other fees charged by Settling Firms to the extent practicable.”²⁷⁹

So, under LIFO, sales during the class period are matched with the latest purchases to compute gains or losses on individual transactions. Since these latest purchases were usually made during the class period, gains resulting from sales during the class period at an artificially inflated price will be included in the damages calculation. Courts using LIFO, which “properly nets out purchases and sales *during* the class period and determines gains or losses in those terms,” are therefore “all of a piece with the concept of ‘actual damages’ recovery that is uniformly embraced” by courts taking the netting approach and viewing compensation as the primary objective of Rule 10b-5.²⁸⁰

3. Law and Accounting

a. *Weak Relationship*

Using inventory methods such as FIFO or LIFO to calculate damages in Rule 10b-5 actions begs the question: what exactly is the relationship between the law and accounting? Perhaps none exists other than the happenstance that some common valuation methods are used in both disciplines. Indeed, the heated debate amongst the courts in Rule 10b-5 actions seems to flow, albeit sometimes inconspicuously, from their particular legal agendas. Not coincidentally, courts advocating deterrence and the transactional approach tend to favor FIFO, which naturally excludes many or all gains during the class period and thereby increases damages.²⁸¹

274. *Id.* at 946.

275. *See In re eSpeed*, 232 F.R.D. at 101.

276. No. 03 Civ.2937(WHP), 2005 WL 217018 (S.D.N.Y. Jan. 31, 2005).

277. *Id.* at *1.

278. *Id.* at *7.

279. *Id.*

280. *See In re Comdisco Sec. Litig.*, 150 F. Supp. 2d 943, 946 (N.D. Ill. 2001).

281. *See, e.g., Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Systems, Inc.*, No. C 01-20418 JW, 2004 U.S. Dist. LEXIS 27008, at *11 (N.D. Cal. May 27, 2004); *In re*

Conversely, courts supporting compensation and the netting approach tend to favor LIFO, which usually recognizes greater gains during the class period and thereby decreases potential damages.²⁸² Choosing a method based solely on such objectives may be completely justified, assuming that courts of law are not at all fettered by accepted principles and standards in the accounting world.

b. *Semistrong Relationship*

A glance at the tortuous history of these inventory methods suggests, however, that the courts have played a considerable role in their development alongside other governmental, regulatory, and professional institutions.²⁸³ LIFO evolved from the “base-stock” method used in England as early as the mid-nineteenth century.²⁸⁴ American companies that adopted these methods during the early 1900s faced stern opposition from the Internal Revenue Bureau, and, by 1919, the Treasury Department permitted taxpayers to use only FIFO and average cost methods for physical inventories.²⁸⁵ Although not specifically addressing the use of LIFO, Justice Louis Brandeis writing for the Supreme Court in *Lucas v. Kansas City Structural Steel Company*²⁸⁶ in 1930 rejected the use of the base-stock method for determining taxable income because it did not “conform with the general or best accounting methods and [was] apparently obsolete.”²⁸⁷ With the defeat dealt by the Supreme Court, advocates of LIFO seeking a new battleground abandoned the courts for the halls of Congress.²⁸⁸ “[I]nitiating by big business’[s] interests, impacted by the economic realities of the Depression and New Deal tax policy, and mediated through the professional aspirations of accountants and policy experts within Congress and the Treasury Department,” LIFO was finally embraced and extended to all taxpayers with the passage of the Revenue Act of 1939.²⁸⁹

The courts have likewise taken part in the continual book-tax conformity debate: “[w]hen book-tax conformity has been put at issue as a matter of substantive tax law by the IRS, the legal and accounting professions, and

Schering-Plough Corp. Sec. Litig., No. Civ.A. 01-0829, 2003 WL 25547564, at *9 (D.N.J. Oct. 10, 2003).

282. See, e.g., *Arenson v. Broadcom Corp.*, No. SA CV 02-301GLT, 2004 WL 3253646, at *2 (C.D. Cal. Dec. 6, 2004); *In re Comdisco*, 150 F. Supp. 2d at 945-46.

283. See, e.g., Stephen C. Lessard, Comment, *Giving Life to LIFO: Adoption of the LIFO Method of Inventory Valuation by the Income Tax Code*, 60 TAX LAW. 781 (2007).

284. *Id.* at 783-84 (“The base-stock method treated the portion of the taxpayer’s inventory considered necessary to the ongoing business of the concern as though it were a fixed asset and valued it at its original cost basis. As the inventory was depleted, it was replaced by new material, which was written down to the original cost of the base-stock. As utilized, inventory above the base-stock level was valued at the lower of cost or market price.”).

285. See *id.* at 786; see also *supra* note 147.

286. 281 U.S. 264 (1930).

287. See *id.* at 269; Lessard, *supra* note 283, at 786-89.

288. See Lessard, *supra* note 283, at 788.

289. See *id.* at 781, 801; see also Revenue Act of 1939, ch. 247, 53 Stat. 862.

the courts, the result has been a well-documented roller coaster ride”²⁹⁰ Stating the general rule for methods of accounting, section 446 of the Internal Revenue Code (the Code) provides that “[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books,” with the broad exception that “[i]f no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”²⁹¹ Even so, where the IRS disallowed an excess inventory write-down and a bad-debt reserve deduction claimed by a taxpayer, the Supreme Court in *Thor Power Tool Co. v. Commissioner*²⁹² found the presumption that the financial reporting treatment of an item was controlling for income tax purposes “insupportable in light of the vastly different objectives that financial and tax accounting have.”²⁹³ Similarly, and more pertinently, while Congress specifically mandated in 1939 that a taxpayer can use LIFO for tax purposes only if the taxpayer also used LIFO for financial reporting purposes, the LIFO conformity requirement has proven anything but straightforward.²⁹⁴

More specifically relating to the use of inventory methods for matching purchases and sales of securities, courts advocating FIFO in Rule 10b-5 actions have relied heavily on Treasury Regulation section 1.1012-1(c) of the Code, which defaults to FIFO for tax purposes when securities cannot be adequately identified.²⁹⁵ As early as 1941, the Supreme Court in *Helvering v. Campbell*,²⁹⁶ addressing a tax dispute over the sale of inherited securities, affirmed the general rule of FIFO reflected in Treasury Regulations that “shares of stock [that] cannot be identified with any particular lots purchased [should] be charged against the earliest purchases.”²⁹⁷ Similarly, the Third Circuit, in reviewing whether a taxpayer was liable for a deficiency in income taxes on the purchase and sale of securities, remarked that FIFO “is so old and well known that any extended explanation of it . . . would be superfluous,” and that “it

290. See Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 112.

291. I.R.C. § 446(a)–(b) (2006); see also I.R.C. § 471 (2006).

292. 439 U.S. 522 (1979).

293. See *id.* at 525–31, 542.

294. See I.R.C. § 472(c), (e) (2006); Treas. Reg. § 1.472-2(e) (2008); Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301, 333–34 (2004) (noting that many commentators believe “the requirement was intended to deter the use of LIFO, on the assumption that LIFO was generally viewed as an unsound accounting method”).

295. See Treas. Reg. § 1.1012-1(c) (2008); see also *supra* notes 253, 259 and accompanying text.

296. 313 U.S. 15 (1941).

297. *Id.* at 20–21.

establishes a presumption to be followed.”²⁹⁸ Especially since the Code straddles both the law and accounting, and in view of its longstanding precedential acceptance, some courts have presumed that the FIFO method accepted for tax purposes is equally suited for Rule 10b-5 actions.²⁹⁹

c. *Strong Relationship*

Considering the deep-rooted link between the courts and these accounting methods, perhaps damages calculations in Rule 10b-5 actions should not only contemplate the Code, but also principles and standards generally accepted for financial reporting. Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing Generally Accepted Accounting Principles (GAAP) to which public financial reporting by U.S. corporations must conform.³⁰⁰ Those standards, officially recognized as authoritative by the SEC³⁰¹ and the American Institute of Certified Public Accountants (AICPA),³⁰² are essential to the efficient functioning of the economy because investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information.³⁰³ The major objective of accounting for inventories, according to the FASB Accounting Standards Codification,³⁰⁴ is the proper determination of income through the process of matching appropriate costs against revenues, which may be determined under any one of several cost flow assumptions, including FIFO, average, and LIFO.³⁰⁵

298. See *Holmes v. Comm’r*, 134 F.2d 219, 221 (3d Cir. 1943); see also *Wood v. Comm’r*, 197 F.2d 859, 863 (5th Cir. 1952).

299. See *supra* Part II.A.1.

300. See Financial Accounting Standards Board, Facts About FASB, <http://www.fasb.org/facts/> (last visited Apr. 5, 2009) [hereinafter Facts About FASB]; Financial Accounting Standards Board, Financial Accounting Standards Advisory Council, <http://www.fasb.org/fasac/> (last visited Apr. 5, 2009).

301. See Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221, 34-47743, IC-26028, FR-70 (Apr. 25, 2003), 68 Fed. Reg. 23,333 (May 1, 2003), available at <http://www.sec.gov/rules/policy/33-8221.htm>. Although the SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Exchange Act, throughout its history the SEC’s policy has been “to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.” Facts About FASB, *supra* note 300.

302. See American Institute of Certified Public Accountants, ET Section 203—Accounting Principles, http://www.aicpa.org/about/code/et_203.html (last visited Apr. 5, 2009); Facts About FASB, *supra* note 300.

303. See Facts About FASB, *supra* note 300.

304. See News Release, FASB Accounting Standards Codification Expected to Officially Launch on July 1, 2009 (Dec. 4, 2008), available at <http://www.fasb.org/news/nr120408.shtml>; see also Bruce Pounder, *Framing the Future: A First Look at FASB’s GAAP Codification*, J. ACCOUNTANCY, May 2008, at 40 (explaining that the codification will be the single source of authoritative GAAP, overriding all existing literature).

305. See FASB Accounting Standards Codification §§ 330-10-10-1, 330-10-30-9 [hereinafter FASB Codification], available at <http://asc.fasb.org/home/>; see also Stephen A. Zeff, Evolution of US Generally Accepted Accounting Principles (GAAP) (July 12, 2004)

Although the FASB's GAAP are currently authoritative in the United States, the International Accounting Standards Board (IASB) has been developing International Financial Reporting Standards (IFRS)—a set of accounting standards that is becoming the global standard for the preparation of public company financial statements.³⁰⁶ As more than 12,000 companies around the world have already adopted IFRS, the SEC, backed by the FASB and the AICPA, has unanimously agreed to a series of steps that could lead to the required use of IFRS by publicly traded companies in the United States by 2014.³⁰⁷ The FASB and the IASB have made great strides to converge the content of IFRS and U.S. GAAP so that most or all of the key differences will be resolved by the time the SEC allows or mandates the use of IFRS for U.S. publicly traded companies.³⁰⁸

(unpublished paper), available at <http://www.iasplus.com/resource/0407zeffusgaap.pdf>. The theoretical foundation for LIFO is in the now largely abandoned "matching principle" popularized during the late 1930s and early 1940s, which emphasized the matching of revenues and expenses in the income statement with assets and liabilities dependent on the outcome of this matching. *Id.* at 4. The Committee on Accounting Procedure issued Accounting Research Bulletin (ARB) 29 in 1947 allowing the FIFO, LIFO, and average methods, and issued ARB 43 in 1953 codifying previous ARBs and confirming LIFO as an accepted accounting method. *Id.* at 5. By 1975, however, the Financial Accounting Standards Board (FASB) unanimously issued Statement of Financial Accounting Standards 2 and 5, signaling its belief in the primacy of balance sheet accuracy with the definitions of assets and liabilities governing the recording of revenues and expenses, not the other way around as under the "matching principle." *Id.* at 17.

306. See American Institute of Certified Public Accountants, IFRS FAQs, http://www.ifrs.com/ifrs_faqs.html (last visited Apr. 5, 2009) [hereinafter IFRS FAQs].

307. See, e.g., Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. REV. 1 (2008); IFRS FAQs, *supra* note 306. For the SEC, see Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, 73 Fed. Reg. 70,815 (proposed Nov. 21, 2008) (to be codified at 17 C.F.R. pts. 210, 229, 230, 240, 244 & 249), available at <http://www.sec.gov/rules/proposed/2008/33-8982fr.pdf>; American Institute of Certified Public Accountants, SEC Unanimously Approves Exposing Proposed IFRS Roadmap for Public Comment, http://www.ifrs.com/updates/sec/SEC_approves.html (last visited Apr. 5, 2009). For the FASB, see A Roadmap for Convergence Between IFRSs and US GAAP—2006–2008: Memorandum of Understanding Between the FASB and the IASB (Feb. 27, 2006) (unpublished memorandum), available at <http://www.iasb.org/NR/rdonlyres/874B63FB-56DB-4B78-B7AF-49BBA18C98D9/0/MoU.pdf>; American Institute of Certified Public Accountants, A Roadmap for Convergence Between IFRS and US GAAP—2006–2008: Memorandum of Understanding Between the FASB and the IASB, <http://www.ifrs.com/updates/fasb/memorandum.html> (last visited Apr. 5, 2009). For the AICPA, see News Release, Am. Inst. of Certified Pub. Accountants, AICPA Statement on SEC Roadmap for IFRS (Aug. 27, 2008), available at http://www.aicpa.org/download/news/2008/AICPA_STATEMENT_ON_SEC_ROADMAP_FOR_IFRS.pdf.

308. See, e.g., Barry J. Epstein, *Early Warning: Recent and Forthcoming Financial Reporting Developments that May Spur Business Litigation*, SEC. LITIG. REP. (Thompson/West, Minn.), Oct. 2006, at 9 (discussing recent GAAP developments and anticipated new standards, with an emphasis on those changes that are most likely to create confusion or opportunities for mischief); Lawrence M. Gill, *IFRS: Coming to America: What CPAs Need to Know About the New Global GAAP*, J. ACCOUNTANCY, June 2007, at 70 (explaining that "it is not simply a philosophical difference between a rules-based approach and a principles-based approach that accounts for the differences between the two systems," but that "[t]he systems differ conceptually on a number of points and can significantly affect an entity's reported results.").

One of the most significant remaining differences, however, is that International Accounting Standard (IAS) 2 does not permit LIFO as an inventory method.³⁰⁹

This mounting tension in the accounting world has been aptly described as “an irresistible force (global convergence) running smack-dab into an immovable object (LIFO),”³¹⁰ since the prohibition of LIFO for financial reporting will likely disqualify LIFO for tax purposes as well.³¹¹ LIFO, which gauges the cost of goods sold in terms of a company’s most recent inventory purchases, results in a lower tax bill than other inventory methods during a period of increasing prices.³¹² In fact, looking for ways to garner more tax revenues, Congressman Charles Rangel introduced a bill in 2007 proposing various tax reforms, including repealing LIFO.³¹³ With the forthcoming convergence and the ban on LIFO for financial reporting, that may be unnecessary given the section 472 conformity rule requiring taxpayers to use the same inventory method for tax purposes and financial reporting.³¹⁴ The SEC has duly noted that companies changing to FIFO “may experience a change in taxable income based on the difference between inventory valued on a LIFO basis and on a FIFO basis.”³¹⁵ While there had been speculation that the FASB, as part of its agreement to converge, would insist upon having an exception for LIFO, that speculation turned out to have been unfounded as the FASB stated in a lengthy letter to the SEC that it “strongly oppose[s]” any such exception.³¹⁶ As it is

309. See IASB International Accounting Standard 2.25 [hereinafter IAS], available at <http://www.iasb.org/IFRSs/IFRS.htm>; see also AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS): AN AICPA BACKGROUNDER 5 (n.d.), available at https://media.cpa2biz.com/Publication/IFRS/1924_IFRS_Backgrounderv3_web_FINAL_06-09-08.pdf.

310. See David M. Katz, *How LIFO Could Stall Global Accounting*, CFO.COM, Dec. 3, 2007, http://www.cfo.com/article.cfm/10239047/c_2984368?f.

311. See, e.g., Dennis J. Gaffney et al., *IRS Provides New Safe Harbors for Taxpayers Using Rolling-Average Inventory Methods*, 109 J. TAX’N 290, 296–97 (2008), available at 2008 WL 4893796; Wolfgang Schön, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAXL. REV. 111, 120 (2005).

312. See, e.g., Helen Shaw, *Will Congress Sink LIFO?: Tax-Cutters on the Prowl for Other Ways to Raise Federal Revenue May Well View Last-In, First-Out Inventory Accounting as Ripe for Repeal*, CFO.COM, July 7, 2006, <http://www.cfo.com/article.cfm/7155954>.

313. See Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007); Shaw, *supra* note 312. Activist groups such as the LIFO Coalition, however, have been fiercely defending the use of LIFO for tax purposes. See LIFO Coalition, *LIFO Repeal Means Massive Tax Increase on Large and Small American Businesses* (May 24, 2006) (unpublished paper), available at <http://www.aednet.org/government/pdf/LIFOBriefer.pdf>; SaveLIFO.org Home Page, <http://savelifo.org/> (last visited Apr. 5, 2009).

314. See I.R.C. § 472(c), (e) (2006); Treas. Reg. § 1.472-2(e) (2008); see also *supra* note 294 and accompanying text.

315. Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, 73 Fed. Reg. 70,815, 70,825 (proposed Nov. 21, 2008) (to be codified at 17 C.F.R. pts. 210, 229, 230, 240, 244 & 249), available at <http://www.sec.gov/rules/proposed/2008/33-8982.pdf>.

316. See Letter from Robert E. Denham, Chairman, Fin. Accounting Found., and Robert H. Herz, Chairman, Fin. Accounting Standards Bd., to Nancy M. Morris, Sec. & Exch.

becoming increasingly clear that “[i]n the debate over whether U.S. companies should adopt international accounting standards the question is no longer if, but when and how,” the convergence between GAAP and IFRS potentially adds a new twist into the equation for choosing a method in Rule 10b-5 actions.³¹⁷

III. EMBRACING DUALITY

As laid out in Part I, the Rule 10b-5 private right of action can be construed narrowly based on the intent of the Exchange Act to deter fraud, or more broadly as a judicial creation with common law roots to compensate investors.³¹⁸ Part II demonstrated the seemingly inevitable dilemma in cases involving gains and losses resulting from the same misrepresentations: selecting a damages approach or accounting method ostensibly entails aligning with one of the two objectives.³¹⁹ *Rocker* and *In re Cigna* exemplify, however, that deciding whether to offset losses by gains need not necessarily involve choosing one objective over the other.³²⁰ Expanding on *Rocker*'s “ongoing trading strategy” test, this part illustrates how the test may not only reconcile the clash between compensation and deterrence but also offer a more sensible means for determining if and when to offset losses by gains.³²¹ This part also concludes that, regardless of the damages approach taken, LIFO is the more appropriate accounting method for Rule 10b-5 actions, notwithstanding that the IRS does not permit taxpayers to use LIFO to match purchases and sales of securities and that it will likely be prohibited for physical inventories in the coming years for both financial reporting and tax purposes.³²²

A. *Choosing a Damages Approach: Welcome to the Rocker Test*

Although many courts and scholars have struggled to confine damages under Rule 10b-5 to a single purpose, and consequently to a specific approach or method in cases involving gains and losses, in truth, “[t]he courts in the context of implied remedies generally have a broad mandate from the Supreme Court to fashion whatever remedies may be appropriate in order to effectuate the general congressional purposes.”³²³ Rather than

Comm'n (Nov. 7, 2007), available at http://www.fasb.org/FASB_FAF_Response_SEC_Releases_msw.pdf; see also George White, *LIFO vs. IFRS: Why the Impediment?*, CPA2Biz.com, June 12, 2008, http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/Tax/impediment.jsp.

317. Emily Chasan, *IFRS May Lead to New U.S. Accounting Divide*, REUTERS, Feb. 14, 2008, <http://www.reuters.com/article/sphereNews/idUSN1449556920080214?sp=true&view=sphere>.

318. See *supra* Part I.C.

319. See *supra* Part II.

320. See *supra* Part II.A.3.

321. See *infra* Part III.A.

322. See *infra* Part III.B.

323. See 3B BLOOMENTHAL & WOLFF, *supra* note 39, § 13:42 (citing *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964)).

taking sides, the reality, as evinced by *Stoneridge*, *Randall*, and *Dura* collectively, is that the Rule 10b-5 private right of action was intended to achieve both deterrence and compensation.³²⁴ Granted, even the Supreme Court has wavered on the relative import and manifestations of these objectives,³²⁵ but, in the end, both should be incorporated in an optimal approach to damages. Yet, when confronted with the problem of gains and losses, most courts have circumvented the issue by siding with one objective or the other instead of fashioning a remedy that encompasses both.³²⁶ Answering the call, the Third Circuit courts in *Rocker* and *In re Cigna* have introduced a test for deciding whether to offset losses by gains that not only obviates the need to choose a single objective but also achieves more equitable damages calculations.³²⁷

1. Ongoing Trading Strategy

Positing that “there may not be a circuit split, but rather a recognition that either approach may be utilized depending on the facts,” *Rocker* went on to rule that the gains and losses should be netted since they resulted from an “ongoing trading strategy.”³²⁸ An ongoing trading strategy ostensibly occurs when an investor consciously makes a chain of investment decisions in which each transaction interrelates with the others. The first important feature of this test is that the transactions are “ongoing”—that an identifiable sequence binds the transactions. An investor that transacts in a company’s stock at different points in time for different reasons, where the decisions are truly unrelated to one another, has not engaged in an “ongoing” strategy. The other prong of this test is that all the decisions can be attributed to a single “strategy”—that the decision maker is aware of and contemplates the previous transactions in the chain when making a decision. An investor that transacts in a company’s stock without any knowledge of or relation to a separately held position in the same stock would not be acting according to a unified strategy. When the criteria of an ongoing trading strategy are met, however, the chain of individual investment decisions can rationally be regarded as one large investment decision merely broken up over time into smaller units.

Although the *Rocker* court framed its inquiry as determining when to apply which approach, the ongoing trading strategy test arguably achieves more by effectively fusing the netting and transactional ideals into one comprehensive approach. The logic behind this test is that a chain of transactions that are sufficiently linked can be considered one long transaction. Offsetting losses by gains within such a chain certainly agrees with the netting approach, which requires offsetting even between unrelated

324. See *supra* Part I.C.2–3.

325. See *supra* Part I.C.2–3.

326. See *supra* Part II.A.1–2.

327. See *supra* Part II.A.3.

328. See *Rocker Mgmt., LLC v. Lernout & Hauspie Speech Prods. N.V.*, No. 00-5965 (PGS), 2007 WL 2814653, at *14–15 (D.N.J. Sept. 24, 2007); see also *supra* Part II.A.3.

transactions. Offsetting losses by gains within a chain also aligns with the transactional approach in that the chain is effectively deemed one long transaction, thus producing only one gain or loss. Even the transactional approach, which breaks trading records down into discrete transactions, offsets losses by gains within a transaction. Just as the typical ups and downs in the stock's price are not split up into gains and losses for a singular transaction, so too the ups and downs from individual components of a unitary transaction should not be separated into gains and losses.

The *Rocker* test thereby, at the very least, obviates the need to choose between compensation and deterrence and, stated more opportunistically, actually embraces and balances the two. Rather than indiscriminately taking either the netting or transactional route, this test runs a given fact pattern through a framework that will only offset losses by gains when doing so coincides with both the netting and transactional thresholds. By not adopting any hard-set rule that will predictably increase or decrease the amount of damages, this test neither supports nor opposes either objective of deterrence or compensation, as the determinative factor lies elsewhere. Better said, the *Rocker* test can be seen as integrating the objectives of deterrence and compensation in a cohesive manner. When an investor executes transactions that are deemed sufficiently linked, it is only fair that the resulting gains and losses are similarly grouped and offset so that the investor is not overcompensated. But when transactions are deemed independent, an investor's recoverable losses are not offset by otherwise legitimate gains, thus allowing for greater deterrence in the form of greater damages.

The *Rocker* test may also resolve the investor/investment incongruity flowing from the point of view taken in a Rule 10b-5 action.³²⁹ As some courts have noted, the Exchange Act provides that no "person" shall recover a total amount in excess of "his" actual damages on account of the act complained of, referring to damages with respect to the investor as a whole and thus justifying the netting approach.³³⁰ Other courts have maintained that section 10(b) and Rule 10b-5 prohibit certain acts in connection with the "purchase or sale of any security," evidently bestowing a separate claim upon each individual investment transaction and thereby coinciding with the transactional approach.³³¹ The ongoing trading strategy test, however, may reconcile these seemingly incompatible terminologies. When an investor engages in an ongoing trading strategy, there is ultimately only one investor and one, albeit unitary, investment transaction and, hence, one net claim for damages. But when an investor's transactions comprise independent trading strategies, the investor's losses on certain investment transactions should not be offset by gains on other transactions that are completely unrelated to his claim for damages.

329. See *supra* notes 143–45 and accompanying text.

330. See *supra* notes 108, 144 and accompanying text.

331. See *supra* notes 44, 145 and accompanying text.

Granted, advocates of the netting approach can still rationalize offsetting losses by gains even across independent trading strategies. After all, the investor's gains and losses result from the same artificial inflation and subsequent drop in the stock's price owing to the alleged misrepresentations.³³² Independent as they may be, the investor arguably receives a windfall by being compensated for losses that were mitigated by corresponding gains.³³³ Moreover, interpreting "actual damages on account of the act complained of" literally suggests that all effects of the alleged act should be accounted for in calculating damages.³³⁴ These contentions are nonetheless counteracted by the reality that investors fortunate enough to have gained from the misrepresentations do not have to give their profits back.³³⁵ With that undisputed shelter for gains in mind, there is ample room to differentiate those circumstances in which an investor's gains remain protected from those in which gains are sufficiently linked to losses so as to require their aggregation in calculating damages.

Perhaps the most valuable aspect of the *Rocker* test, in contrast to the rigid netting and transactional approaches, is the fruition of a more evenhanded mechanism for calculating damages. On one hand, the netting approach might be too harsh on investors by automatically reducing losses by completely independent and unrelated gains, even though investors that fortuitously enjoyed only gains from the misrepresentations are not required to give them back. On the other hand, the transactional approach that arbitrarily cherry-picks the losing transactions but ignores the gains not only unduly benefits an investor who made a string of related transactions but also creates a perverse incentive for investors intentionally to seek out fraudulent companies, knowing that they can keep their gains and still recover their losses. The discerning ongoing trading strategy test, however, avoids these unjust and undesirable shortcomings by offsetting transactions if, and only if, they are sufficiently linked.

2. Independent Trading Strategies

After presenting an impartial overview of the damages approach controversy, *In re Cigna* recognized that offsetting losses by gains may not always be appropriate and thus entertained "the vitality of transaction-based methodologies on [its] facts."³³⁶ A prime example is where an investor disperses his assets among various independent managers, with each manager investing according to his own strategy. Suppose Investor Bear decides to invest his money in two funds. Bear gives his money to these funds but has no specific knowledge of how these funds choose to invest his money. One fund sells its position in Fraud, Inc. during the class period at

332. See WONG, *supra* note 137, at 16.

333. See *supra* notes 166–68 and accompanying text.

334. 15 U.S.C. § 78bb(a) (2006); see also *supra* note 108 and accompanying text.

335. See Pritchard, *supra* note 59, at 224.

336. See *In re Cigna Corp. Sec. Litig.*, 459 F. Supp. 2d 338, 354 (E.D. Pa. 2006).

an artificially inflated price for a gain, while the other fund sells its position in Fraud, Inc. after corrective statements are made and the stock's price drops, resulting in a loss. Bear thus recognizes a gain and a loss as a result of the same misrepresentations. Since these two funds engaged in independent trading strategies and Bear had no control of any of his positions in Fraud, Inc., however, offsetting his losses by his gains may not be appropriate.

A somewhat more novel situation is where an investor allocates his money between multiple independent funds and manages these funds separately according to different strategies. Suppose Investor Merrill creates two funds, Fund A and Fund B. Merrill happens to purchase shares of Fraud, Inc., among others, in both funds. During 2007, Merrill needs some cash and liquidates his positions in Fund A and realizes a gain on his sale of Fraud, Inc. at an artificially inflated price. Merrill later sells his positions in Fund B in 2008 after corrective statements are made and the stock's price drops, resulting in a loss. So Merrill realizes a gain from Fund A and a loss from Fund B on his holdings in the same stock, although his decisions to sell his positions in Fraud, Inc. were completely unrelated to each other. Since Merrill did not engage in an ongoing strategy to manage his positions in Fraud, Inc., offsetting his losses by his gains may not be appropriate.

Another case in point is where an investor makes a number of independent decisions concerning the same stock. Suppose Investor Lehman purchases shares of Fraud, Inc. in 2006 and then sells all of them in 2007 for a gain at an artificially inflated price. Later on in 2007, Lehman again purchases shares of Fraud, Inc. but sells them in 2008 after corrective statements are made and the stock's price drops, resulting in a loss. As a result of the same misrepresentations, Lehman realizes a gain on his first transaction and a loss on his second transaction. Lehman's second transaction, however, was clearly unrelated to his first transaction since he had already cleared his entire position from his first decision by the time he made his second decision some time later. Accordingly, offsetting Lehman's loss from his second transaction by the gain from his first transaction may not be appropriate.

A natural drawback exposed by these hypotheticals is the court's added labor in determining whether an investor's transactions constitute an ongoing trading strategy. First, deciding when a group of transactions are "ongoing" entails identifying some sort of consistency or pattern over a period of time that links them together. How long the time period or how interspersed the transactions can be, for example, are fact-sensitive questions that must be evaluated. Moreover, the "strategy" requirement is both subjective and relative, since it hinges on the investor's intent in making investment decisions. Even the investor might have difficulty ascertaining the various conscious and possibly subconscious factors that contributed to a particular decision and how it related to others. Despite these obstacles, *Rocker* demonstrates that it is often readily apparent from

trading records whether an investor engaged in an ongoing trading strategy. For less obvious cases, though, the ball indeed falls in the courts' court to define the bounds of an ongoing trading strategy.

B. *Choosing an Accounting Method: LIFO In, LIFO Out?*

The accounting method debate, although obliquely enmeshed in the same conflict between the dual objectives of Rule 10b-5, should really be about properly accounting for gains and losses that accrued during the class period. Courts have occasionally utilized these accounting methods as a means to achieve a preconceived end—to increase or decrease damages in line with their aims of deterrence or compensation—rather than objectively considering which method more accurately reflects the true economic effect of securities transactions.³³⁷ Not only is such an objective consideration called for by the law of “actual damages” under Rule 10b-5,³³⁸ but the principles and standards concerning the use of FIFO and LIFO in the accounting world may also pertain.³³⁹ While LIFO is clearly the more accurate measure of damages in Rule 10b-5 actions, however, it may be waning as a generally acceptable method pursuant to rising international principles and standards.

1. The Case for LIFO

While the same fundamental principles ought to apply to the FIFO and LIFO methods most commonly associated with physical inventories when utilized for other purposes, a noteworthy caveat to the particular application of these methods in Rule 10b-5 actions is the inability for consistency to balance out results over many reporting periods. With physical inventories, as long as a method is applied consistently, “the basis of stating inventories does not affect the overall gain or loss on the ultimate disposition of inventory items,” since all items will eventually be accounted for, whereas “any inconsistency in the selection or employment of a basis may improperly affect the periodic amounts of income or loss.”³⁴⁰ Because of the “common use and importance of periodic statements” in financial reporting, consistency is essential so that “the results reported may be fairly allocated between years.”³⁴¹ When calculating damages under Rule 10b-5, however, only one period—the class period—matters. The method used to match transactions during the class period will determine the extent of gains and losses, as well as which gains and losses are included altogether, and these results will not be tempered by other periods. Choosing the most appropriate inventory method in this context is therefore even more critical than it is in ordinary cost flow situations.

337. See *supra* notes 281–82 and accompanying text.

338. 15 U.S.C. § 78bb(a) (2006); see also *supra* note 108 and accompanying text.

339. See *supra* Part II.B.3.

340. FASB Codification, *supra* note 305, § 330-10-30-15.

341. *Id.*

As another aside, two alternative and occasionally more intuitive inventory methods not even considered in Rule 10b-5 actions are “specific identification” and “weighted-average.”³⁴² Specific identification, which “attaches the actual cost to an identifiable unit of product,” is clearly the method that provides “the most precise matching of costs and revenues.”³⁴³ In fact, instead of defaulting to FIFO, the IRS allows investors to use specific identification for tax purposes by matching sales with purchases in whatever manner they choose, if specific shares were designated to be sold at the time of sale.³⁴⁴ However, specifically identifying the shares for all purchases and sales of securities is usually an impractical task for investors, just as is most often the case with physical inventories.³⁴⁵ The weighted average method, which “is a means of costing ending inventory using a weighted-average unit cost,”³⁴⁶ is likewise not particularly apt for Rule 10b-5 actions. First, weighted average does not actually match the individual purchases and sales of securities.³⁴⁷ Moreover, using this method would be quite burdensome since evaluating continuous purchases and sales of securities throughout the class period would require a “moving” weighted average³⁴⁸ used for perpetual inventory systems³⁴⁹ as opposed to the simple weighted average used for periodic inventory systems.³⁵⁰

Given the infeasibility of specific identification and weighted average in Rule 10b-5 actions, one possible factor to consider in differentiating between FIFO and LIFO would be which method better captures the actual

342. See HERMANSON, EDWARDS & MAHER, *supra* note 147, at 265–66, 268.

343. *Id.* at 265, 284.

344. See 26 C.F.R. § 1.1012-1(c) (2008); see also WONG, *supra* note 137, at 5; *supra* note 295 and accompanying text.

345. See BRAGG, *supra* note 147, at 121 (“This approach is rarely used, because the amount of paperwork and effort associated with developing unit costs is far greater than under all other valuation techniques. It is most applicable in businesses such as home construction, where there are few units of inventory to track, and where each item is truly unique.”); FASB Codification, *supra* note 305, § 330-10-30-11 (“[I]f the materials purchased in various lots are identical and interchangeable, the use of identified cost of the various lots may not produce the most useful financial statements. This fact has resulted in the general acceptance of several assumptions with respect to the flow of cost factors such as FIFO, average, and LIFO to provide practical bases for the measurement of periodic income.”); IAS, *supra* note 309, 2.24 (“[S]pecific identification of costs is inappropriate when there are large numbers of items of inventory that are ordinarily interchangeable.”).

346. HERMANSON, EDWARDS & MAHER, *supra* note 147, at 268.

347. See *supra* note 146 and accompanying text.

348. See HERMANSON, EDWARDS & MAHER, *supra* note 147, at 272 (“Under perpetual inventory procedure, firms compute a new weighted-average unit cost after each purchase by dividing total costs of goods available for sale by total units available for sale. The unit cost is a moving weighted-average because it changes after each purchase.”).

349. See BRAGG, *supra* note 147, at 237 (defining “perpetual inventory” as “[a] manual or automated inventory tracking system in which a new inventory balance is computed continuously whenever new transactions occur”); HERMANSON, EDWARDS & MAHER, *supra* note 147, at 262–65.

350. See HERMANSON, EDWARDS & MAHER, *supra* note 147, at 262 (“Under periodic inventory procedure . . . [c]ompanies determine cost of goods sold only at the end of the period as the difference between cost of goods available for sale and ending inventory.”).

flow of inventory. For physical inventories, and particularly in the case of perishable goods, FIFO better “corresponds with the actual physical flow of goods” since the first units bought will typically be the first units sold.³⁵¹ For the purpose of matching purchases and sales of securities, however, LIFO may in fact be the more plausible interpretation of the investor’s decision-making process. Very often, after building up a substantial position in a company’s stock over time, an investor will continue to purchase and sell additional shares. These new purchases and sales more likely reflect a reversed decision to add to the investor’s position rather than the purchase of a new position and the liquidation of the old position.³⁵² Pairing a recent purchase and sale transaction therefore often makes more economic sense than pairing the sale with an older purchase.³⁵³

More important than the argument that LIFO may better correspond with the actual flow of securities, according to GAAP, “[t]he major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.”³⁵⁴ This guiding principle pertains equally to damages calculations in Rule 10b-5 actions, where the indisputable objective is to quantify the gain or loss that occurred during the class period. In this respect, as many of the courts advocating LIFO have pointed out, FIFO allows an investor to exclude arbitrarily many or all gains from the class period by matching sales with purchases made prior to the class period. This is not a normal function of FIFO—it is an unintended side-effect in the Rule 10b-5 context. LIFO, on the other hand, generally recognizes gains occurring during the class period by matching sales with the latest purchases and is therefore the method that better reflects periodic income in Rule 10b-5 actions.³⁵⁵

Some courts using FIFO are not only aware of this anomalous outcome in Rule 10b-5 actions, but actually insist that it makes FIFO the better measure of gains and losses during the class period. These courts maintain that unless the entire transaction—purchase and sale—occurs after the inception of the class period, then the gain or loss should not be counted.³⁵⁶ While this contention seems tenable, it sorely misses the point of damages under Rule 10b-5—to measure “the impact of the defendant’s nondisclosures on the market value of the stock.”³⁵⁷ That an investor purchased or sold short shares before the class period does not negate the reality that the inflated stock price resulting from the defendant’s misrepresentations caused some amount of gain or loss on the sale or cover

351. *Id.* at 266.

352. *See* WONG, *supra* note 137, at 5.

353. *See id.* Concededly, this speculation does not necessarily describe many investors’ behavior; rather, they might look at the total weighted average cost of their positions in deciding to reverse purchases and lighten their holdings.

354. *See* FASB Codification, *supra* note 305, § 330-10-30-9; *see also supra* note 305 and accompanying text.

355. *See* Part II.B.

356. *See supra* note 252 and accompanying text.

357. 26 KAUFMAN, *supra* note 4, § 1.4.

to purchase during the class period that would not have otherwise occurred. Unlike FIFO, LIFO generally includes these gains or losses resulting from an inflated stock price by matching sales with the latest purchases, which were usually made during the class period.³⁵⁸

This understanding likewise rebuts those courts using FIFO on the grounds that the IRS defaults to FIFO for tax purposes.³⁵⁹ The IRS most likely allows taxpayers to use FIFO to match purchases and sales of securities for the simple reason that this method generates higher tax revenues.³⁶⁰ Because the stock market (presumably) rises over the long run, matching sales with the earliest purchases will more often than not trigger greater taxable gains.³⁶¹ The IRS does not deal with the coincidental ramifications of FIFO in Rule 10b-5 actions, however, in which transactions are completely excluded. Rest assured, the IRS would not allow FIFO if it enabled investors to completely avoid taxable gains. Consequently, the IRS's use of FIFO for tax purposes does not necessarily imply that FIFO is the more appropriate method for securities transactions, and certainly not for Rule 10b-5 actions.

2. The Case Against LIFO

Despite the compelling argument for LIFO in Rule 10b-5 actions and the insignificance of the IRS's approval of FIFO for matching purchases and sales of securities for tax purposes, the looming demise of LIFO in the accounting world may be reason for concern. The convergence between GAAP and IFRS, coupled with the book-tax conformity rule, most likely spells the end of LIFO for physical inventories for both financial reporting and tax purposes.³⁶² Whether the ban signifies a greater fundamental and categorical rejection of LIFO for all kinds of inventories and valuations,

358. Gains could technically be excluded under LIFO as well if more shares were sold than all class period purchases, so that some sales would have to be matched with preclass period purchases. A more effective solution to this problem of excluding gains or losses may lie in a "mark-to-market" regime that revalues the shares held before the class period to the stock's market price as of the inception of the class period, and then uses that value for computing damages under FIFO or LIFO. Mark-to-market is now a generally accepted accounting methodology of assigning a value to a position held in a financial instrument based on its current market price. See FASB Statement of Financial Accounting Standards 157; FASB Codification, *supra* note 305, § 320-10-35-1; IAS, *supra* note 309, 39.46. As courts have not yet considered such a system in Rule 10b-5 actions, this Note merely undertakes to resolve which unmodified method, FIFO or LIFO, is the better of the two.

359. See *supra* notes 253–54, 259 and accompanying text.

360. See WONG, *supra* note 137, at 5.

361. See *id.* at 5 n.12; see also *In re Comdisco Sec. Litig.*, No. 01 C 2110, 2004 WL 905938, at *2 (N.D. Ill. Apr. 26, 2004) (“[T]he reasons for that treatment for income tax purposes are readily apparent: In light of the long-term trend of increasing values in stocks, plus the facts (1) that FIFO rather than LIFO therefore typically increases the measurement of currently recordable gains and (2) that stocks held until death get a stepped-up basis while at the same time escaping income taxation entirely, what other approach might be expected from taxing authorities who are properly interested in maximizing the benefits to the fisc?”).

362. See *supra* Part II.B.3.c.

however, remains unclear. While IAS 2, which bans LIFO,³⁶³ technically excludes certain kinds of inventories—including financial instruments—from its scope,³⁶⁴ that can be attributed to their separate and more detailed treatment in other standards.³⁶⁵ Moreover, even if IAS 2 is not necessarily aimed at all kinds of inventories and valuations, its ban on LIFO may ultimately flow through to other areas, such as the matching of purchases and sales of securities, via implicated U.S. GAAP standards and Code provisions.

Supposing the ban on LIFO for physical inventories for financial reporting and tax purposes does mushroom into the general repudiation of the method in all circumstances, courts calculating damages in Rule 10b-5 actions may want to reconsider using a method rendered obsolete in the accounting world. Clearly, the methods used in securities litigation are not actually bound by financial reporting and tax authorities—especially where the courts have soundly distinguished the inapposite outcomes FIFO produces in Rule 10b-5 actions from ordinary cost flow situations. At the same time, the courts have historically cooperated with other governmental, regulatory, and professional institutions in determining how and when these methods should be used.³⁶⁶ Even though the logic for LIFO in Rule 10b-5 actions has not changed, nor should it necessarily hinge on tax laws or financial reporting standards, the loss of LIFO for real inventory costing will likely relegate it to a position of less familiarity and acceptance. That said, courts should continue to use LIFO, but look out for actions taken by the SEC, IRS, FASB, IASB, AICPA, and Congress in the coming years that could potentially reach damages calculations in Rule 10b-5 actions.

CONCLUSION

Promulgated under section 10(b) of the Exchange Act to deter fraud but modeled after common law tort actions to compensate investors, the Rule 10b-5 private right of action was a circuit split waiting to happen.³⁶⁷ Most courts encountering the problem of gains and losses have systematically fallen in line with either of the opposing damages approaches and accounting methods stemming from the seemingly conflicting origins and objectives of Rule 10b-5.³⁶⁸ This Note, however, presents a roadmap for calculating damages that embraces its inherent duality and properly accounts for gains and losses during the class period.³⁶⁹ First, this Note contends that losses should be offset by gains if, and only if, they are sufficiently linked by an ongoing trading strategy.³⁷⁰ Second, this Note

363. See IAS, *supra* note 309, 2.25; see also *supra* note 309 and accompanying text.

364. See IAS, *supra* note 309, 2.2(b).

365. See *id.* 32, 39.

366. See *supra* Part II.B.3.b–c.

367. See *supra* Part I.C.

368. See *supra* Part II.

369. See *supra* Part III.

370. See *supra* Part III.A.

concludes that LIFO is the more appropriate method for matching purchases and sales of securities despite contrary tax laws and developments in the accounting world.³⁷¹ Rather than surmising that “the function of securities law is ‘the protection of investors’ or ‘compensation for wrongs,’” these proposals aspire to the paramount objective of “efficient operation of the markets.”³⁷² In that way, as “every great work of art has two faces, one toward its own time and one toward [the future],”³⁷³ the deep-rooted yet dynamic Rule 10b-5 may entertain the new day’s challenge of calculating damages.

371. See *supra* Part III.B.

372. See Easterbrook & Fischel, *supra* note 129, at 613; *supra* text accompanying note 131.

373. DANIEL BARENBOIM & EDWARD W. SAID, PARALLELS AND PARADOXES: EXPLORATIONS IN MUSIC AND SOCIETY 52 (Vintage Books 2004) (2002).