YET ANOTHER BOUGH ON THE "JUDICIAL OAK"[1]: THE SECOND CIRCUIT CLARIFIES INQUIRY NOTICE AND ITS LOSS CAUSATION REQUIREMENT UNDER THE PSLRA IN *LENTELL V. MERRILL LYNCH & CO.*

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"October. This is one of the peculiarly dangerous months to speculate in stocks in. The others are July, January, September, April, November, May, March, June, December, August, and February." [2]

INTRODUCTION

Mark Twain's timeless quip, coined over a century ago by the sage-like curmudgeon, serves as a fitting prologue to this Comment. Even when viewed through the rose-tinted lenses of hindsight bias[3] and with an appreciation of the efficient capital markets hypothesis,[4] Wall Street arguably remains the same

[1] The Supreme Court signaled its acceptance of a private right of action under section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5, promulgated thereunder, with then Justice Rehnquist's legendary phrase: "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it . . . ." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

This Comment's title alludes to *Lentell v. Merrill Lynch & Co.*'s, 396 F.3d 161 (2d Cir. 2005), place among those watershed decisions construing and applying the antifraud provisions of the federal securities laws.

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[2] MARK TWAIN, THE TRAGEDY OF PUDD'NHEAD WILSON 166 (Am. Publ'g Co. 1900) (1894).

[3] *See, e.g.*, Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 571–73 (1998) (discussing retrospective legal assessments and the "prejudicial aspects of judging in hindsight" especially in the realm of securities fraud).

[4] Credit for the study of the economic implications of the efficient capital markets hypothesis belongs to University of Chicago Economics Professor Eugene F.

fickle yet alluring mistress it was when Twain put pen to paper. From time in memorial, echoes of a mantra could be heard from the Street: one person's loss is another's gain.[5] The past decade—awash with waves of frenzied, high-risk speculation—was aptly epitomized the era of "irrational exuberance."[6] At the risk of sounding profound, the resulting deluge of securities litigation was inevitable, particularly in the area of analyst conflicts of interest. Disappointed investors invoked the securities laws in hope of recouping their losses.

The federal courts have construed section 10(b)[7] of the Exchange Act and its regulatory counterpart, Securities and Exchange Commission Rule 10b–5,[8] as collectively establishing a private right of action for fraud and misrepresentation under the federal securities laws.[9] Litigants alleging a violation of these

Fama and his seminal article, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FINANCE 383 (1970). *See also* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 910–11 (1989) ("The efficient capital markets hypothesis posits that stock prices quickly reflect information without bias. . . . The empirical evidence to date (with some exceptions) appears to establish the validity of the weak and semi-strong versions but not the strong form of the efficient capital markets hypothesis."); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549–50 (1984) (addressing how the theory has influenced a reassessment of the modern securities law, judicial decisions, and the practice of law); Marvin G. Pickholz & Edward B. Horahan III, *The SEC's Version of the Efficient Market Theory and Its Impact on Securities Law Liabilities*, 39 WASH. & LEE L. REV. 943, 943 (1982) ("The efficient market theory . . . affects both the methods and responsibilities of disclosure as mandated by the securities laws.").

[5] At least two scholars posit that P.T. Barnum's adage, "[T]here's a sucker born every minute," was apropos to the present state of affairs on Wall Street. *See* Barbara Black & Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. PITT. L. REV. 483, 486 (2003) (noting that "the inexperience and naiveté of . . . investors may be yet another occasion for P.T. Barnum cynicism").

[6] It was Federal Reserve Chairman Alan Greenspan who coined the idiom "irrational exuberance," connoting a decade of high-risk trading by investors with little or no knowledge of the market forces at play. *See* ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 3 (2000).

[7] 15 U.S.C. § 78j(b) (2000) ("It shall be unlawful for any person . . . (b) To use or employ . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . .").

[8] 17 C.F.R. § 240.10b–5 (2004) ("It shall be unlawful for any person . . . (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .").

[9] *See supra* note 1 and accompanying text. The federal courts first recognized a private cause of action under section 10(b) and Rule 10b-5 in the case of *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513–14 (E.D. Pa. 1946), and the Supreme Court affirmed this judge-made private right of action in *Blue Chip Stamps v. Manor*

general antifraud provisions confront a Homeric dilemma as they attempt, often unsuccessfully,[10] to navigate the waters between the statutory Scylla and Charybdis embodied in the loss causation requirement forged under section 21D(b)(4)[11] of the Private Securities Litigation Reform Act of 1995 (the "PSLRA")[12] and the inquiry notice trigger that commences the running of the antifraud provisions' statute of limitations.[13]

Recently, in *Lentell v. Merrill Lynch & Co.*,[14] Judge Dennis Jacobs, writing for a unanimous panel of the United States Court of Appeals for the Second Circuit, clarified two frequently litigated aspects of the PSLRA.[15] In affirming, though reversing in part, the district court's dismissal of two consolidated securities fraud class actions,[16] the Second Circuit: (1) clarified that only detailed information relating directly to the alleged misrepresentations and omissions of the defendant will trigger

Drug Stores, 421 U.S. 723, 737 (1975). *See, e.g.*, Herman & MacLean v. Huddleston, 459 U.S. 375, 380 n.10 (1983).

[10] In complex litigation such as securities class actions, to sue is human, to settle divine. Not surprisingly, one commentator notes that she was "unaware of any case awarding damages to an investor who brought a claim for securities fraud under the [Exchange Act] against an analyst or other industry participant lacking a fiduciary duty to the investor for recommending a security in a research report without disclosing conflicts of interest." Jill I. Gross, *Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?*, 2002 COLUM. BUS. L. REV. 631, 661 (2002).

[11] 15 U.S.C. § 78u–4(b)(4) (2000) ("In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter *caused the loss* for which the plaintiff seeks to recover damages.") (emphasis added).

[12] Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

[13] 15 U.S.C. § 78i(e) (2000) ("No action shall be maintained to enforce any liability created under this section, unless brought within *one year after the discovery* of the facts constituting the violation and within three years after such violation.") (emphasis added). Unlike the situation in *Lentell*, for claims brought after the August, 29, 2002 effective date of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (amending 28 U.S.C. § 1658), the statute of limitations was increased to two years after discovery and to five years after the violation. *See* § 804, 116 Stat. at 801.

[14] 396 F.3d 161 (2d Cir. 2005).

[15] The circuit held that the actions were timely filed. *Id.* at 164. It affirmed the underlying dismissal, however, "on the ground that the complaints fail to plead that the alleged misrepresentations and omissions caused the claimed losses." *Id.*

[16] *Lentell* was the product of two putative class action complaints, 24/7 Real Media, Inc., No. 02-CV-3210 (MP), and Interliant, Inc., No. 02-CV-3321 (MP), consolidated by the Judicial Panel on Multi-District Litigation into one docket, No. 02-MDL-1484 (MP), for ease of administration. *See id.* at 165; *In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 357, 359 n.14 (S.D.N.Y. 2003).

the inquiry notice provision applicable to the statute of limitations[17] and, more notably, (2) elucidated prior circuit opinions dealing with the elusive and ever fluid concept of loss causation, providing hornbook-like guidance on the Second Circuit's stringent standard for pleading loss causation, especially in suits premised on analysts' conflicts of interest.[18] *Lentell* was immediately touted as "'a very significant decision for the securities litigation bar.'"[19] This Comment critically examines the decision, focusing on the circuit's meticulous analysis of both inquiry notice and the loss causation requirement.

It is submitted that the Second Circuit's decision in *Lentell* bolsters the already Sisyphean task of pleading securities fraud under the PSLRA, especially for claims based solely on analysts' conflicts of interest. In doing so, the Second Circuit advanced Congress's statutory intentions in drafting the PSLRA a decade ago—curbing abusive private securities litigation[20]—rather than

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[17] *See infra* Part II.A.

[18] *See infra* Part II.B.

[19] Mark Hamblett, *Investors' Failure to Link Merrill's Reports to Losses Is Fatal to Suits*, N.Y. L.J., Jan. 21, 2005, at 1 (quoting counsel for Merrill Lynch, Jay B. Kasner of Skadden, Arps, Slate, Meagher & Flom). With front-page, color-coverage the day after the circuit announced it decision, the *New York Law Journal* reported that the decision "raises the bar high for suits based on analyst recommendations and jeopardizes dozens of such actions against Merrill Lynch." *Id.*; *see also* Phyllis Diamond, *2d Cir. Sees No Loss Causation in Fraud Claims Based on Analyst Reports*, 37 SEC. REG. & L. REP. (BNA) 173 (2005) (reporting that Marc B. Dorfman of Foley & Lardner in Washington D.C. commented that *Lentell* is "significant . . . because it clarifies the Second Circuit's standard for pleading loss causation"); Martin Flumenbaum & Brad S. Karp, *Loss Causation in the Research Analyst Cases (and Beyond)*, N.Y. L.J., Jan. 26, 2005, at 3 ("Much of the confusion that has long been associated with loss causation was stripped away by the court's forceful and unvarnished opinion in *Lentell*.").

[20] *See Lentell*, 396 F.3d at 171 ("[T]he congressional intent of the PSLRA [was] 'to deter strike suits wherein opportunistic private plaintiffs file securities fraud claims of dubious merit in order to exact large settlement recoveries.'" (quoting Novak v. Kasaks, 216 F.3d 300, 306 (2d Cir. 2000))); *see also* James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 907–08 (1996) (arguing that based on empirical evidence most of the securities fraud class actions filed are strike suits, whereby the putative plaintiff classes are seeking a profitable settlement rather than trial).

For a comprehensive overview and critique of the legislative history behind the PSLRA, see John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996); David S. Escoffery, Note, *A Winning Approach to Loss Causation Under Rule 10B-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 FORDHAM L. REV. 1781, 1809–15 (2000).

averting the clear congressional mandate as other circuits had done.[21] This Comment argues that *Lentell*'s precedential value lies in its clarification of the murky waters surrounding the circuit's narrow reading of the loss causation standard that were muddied, in part, by other Second Circuit decisions. The circuit reconfirmed that a fact-specific inquiry into the causal link between the fraud and the drop in price is still an indispensable touchstone of pleading securities fraud. As a result of the *Lentell* court's analysis, the circuit reset the benchmark of its loss causation pleading standards to the heightened level originally intended by Congress under the PSLRA. Additionally, although of somewhat lesser jurisprudential import than the circuit's tutorial on loss causation, *Lentell* reemphasized that generalized "storm warnings" of market-wide research analysts' conflicts do not trigger the statute of limitations' inquiry notice provision. *Lentell* will unquestionably increase the mortality rate for securities fraud cases[22] still lingering on the federal docket,[23]

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[21] Historically, there was a circuit split, a full discussion of which is well beyond the scope of this Comment, regarding the proper loss causation standard under the PSLRA. The Eighth and Ninth Circuits took a more lenient artificial price inflation approach, while the Second, Third, Fourth, Seventh, and Eleventh Circuits require a more stringent showing of a foreseeable and direct causal connection between the alleged fraud and the stock's drop in price.

This circuit split led the Supreme Court to grant certiorari in a Ninth Circuit case, *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir. 2003), *cert. granted*, 124 S. Ct. 2904 (2004). *See, e.g.*, Gregory A. Markel et al., *Pleading Loss Causation in Securities Litigation*, N.Y. L.J., Oct. 18, 2004, at S6. On review, the Supreme Court, with Justice Breyer delivering the unanimous opinion of the Court, firmly disagreed with the Ninth Circuit's artificial price inflation theory and affirmed the Second, Third, Seventh, and Eleventh Circuit's requirement for a causal link between the fraud and the drop in price. *See* Dura Pharms., Inc. v. Broudo, No. 03-932, 2005 WL 885109 (U.S. April 19, 2005), at *1, 125 S. Ct. 1627 (2005).

[22] *See, e.g.*, Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*,*"* 108 HARV. L. REV. 438, 446 (1994) (extrapolating data showing that "a substantial percentage of all federal securities class actions filed were dismissed on motions before trial").

[23] *See* Flumenbaum & Karp, *supra* note 19; *see also, e.g.*, *In re* Initial Public Offering Secs. Litig., No. MDL 1554(SAS), 2005 WL 743550, at *1, *5 nn.63–64, *7 n.82, *12 n.119 (S.D.N.Y. April 1, 2005) (citing various aspects of *Lentell* as authority for granting defendant's motion to dismiss with prejudice); Hampshire Equity Partners II, L.P. v. Teradyne, Inc., 04 Civ. 3318(LAP), 2005 WL 736217, at *1, *4–5 (S.D.N.Y. Mar. 30, 2005) (same); *In re* Salomon Analyst, 02 Civ. 6801(GEL), 2005 WL 550847, at *1 (S.D.N.Y. Mar. 8, 2005) (staying all proceedings, such as discovery, during the pendency of defendant's motion to dismiss, which was filed as a result of the *Lentell* decision); Clark v. Nevis Capital Mgmt., LLC, 04 Civ.

especially those premised on analysts' conflicts. Moreover, *Lentell* arguably "paved the way for the Supreme Court's opinion in *Dura Pharmaceuticals*,"[24] where the circuit split over the proper loss causation requirement was recently laid to rest.[25]

Part I of this Comment begins with an overview of the underlying claims at issue in *Lentell* and the district court's rationale for dismissing those claims on the pleadings.[26] Part II provides a synopsis of the concerns surrounding securities analysts' conflicts of interest as a backdrop for the legal analysis employed by the circuit.[27] Part III focuses on the two issues that *Lentell* illuminated: the inquiry notice provision applicable to the statute of limitations[28] and the loss causation requirement under the PSLRA.[29] Ultimately, the Comment concludes with the author's forecast of *Lentell*'s weight and moment on pending, and yet to be filed, securities fraud litigation.

I. BACKGROUND

The plaintiffs in *Lentell* were a putative class of jaded, non-client purchasers[30] who bought shares in certain Internet-related companies during the waning portion of the technology stock boom.[31] The defendants were Wall Street titans, Merrill Lynch & Company and Henry M. Blodget, Merrill Lynch's infamous research analyst,[32] who published research reports

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2702(RWS), 2005 WL 488641, at *1, *7, *16 (S.D.N.Y. Mar. 2, 2005) (citing *Lentell* as authority for granting, in part, defendant's motion to dismiss yet allowing plaintiffs leave to replead); ATSI Communications, Inc. v. Shaar Fund, Ltd., 357 F. Supp. 2d. 712, 717 & n.36 (S.D.N.Y. 2005) (citing *Lentell* as authority for granting defendant's motion to dismiss with prejudice); *In re* Recoton Corp. Sec. Litig., 358 F. Supp. 2d. 1130, 1138 & n.4 (M.D. Fla. 2005) (citing *Lentell* as authority for granting defendant's motion to dismiss, without prejudice, and allowing plaintiffs leave to replead).

[24] Flumenbaum & Karp, *supra* note 19.

[25] *See supra* note 21 and accompanying text.

[26] *See infra* notes 30–60 and accompanying text.

[27] *See infra* notes 61–82 and accompanying text.

[28] *See infra* notes 93–122 and accompanying text.

[29] *See infra* notes 123–75 and accompanying text.

[30] These investors had no contractual or fiduciary relationship with the investment firm, Merrill Lynch. *See In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 357 (S.D.N.Y. 2003) ("No customer relationship with defendants is claimed by the plaintiffs; no fiduciary or contractual relations existed . . . .").

[31] The plaintiffs purchased shares in 24/7 Real Media, Inc. and Interliant, Inc. between the period of May 12, 1999 and February 20, 2001. *See id.* at 360.

[32] The defendants from *Merrill Lynch* were Merrill Lynch & Co., its wholly-

recommending the purchase of shares in certain Internet companies.[33] The reports purported to reflect the analysts' opinions on the competitive position of these investments, evaluations of past performance, and projections of estimated future performance.[34] Moreover, the reports contained a rating system encompassing both the investment risk and the appreciation potential of the companies in question.[35] Of particular analytical significance in the *Lentell* opinion was the fact that Merrill Lynch's reports indicated the highly volatile level of investment risk for these stocks[36] but, nonetheless, forecasted substantial appreciation potential.[37] The plaintiffs claimed, inter alia, that the non-disclosure of securities analysts' conflicts of interest led Merrill Lynch to issue "false and misleading reports recommending that investors purchase shares" in these Internet ventures.[38] The plaintiffs' calculus, however, erroneously equated the non-disclosure of these conflicts of interest to a violation of federal securities laws' antifraud provisions.[39]

Presiding over the underlying class actions was the recently deceased Senior Judge for the Southern District of New York, Milton Pollack,[40] who was no stranger to this genre of complex

owned subsidiary Merrill Lynch, Pierce, Fenner & Smith Inc., and individual defendant, Henry Blodget, the former first vice president of Merrill Lynch's internet sector. *See id.* at 355. On appeal, however, only Merrill Lynch & Co. and Mr. Blodget were named as defendants-appellees. *See* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 164 (2d Cir. 2005).

[33] *See Lentell*, 396 F.3d at 165–67; *Merrill Lynch*, 273 F. Supp. 2d at 359–60.

[34] *See Lentell*, 396 F.3d at 165–67; *Merrill Lynch*, 273 F. Supp. 2d at 361.

[35] *See Lentell*, 396 F.3d at 166 & n.1; *Merrill Lynch*, 273 F. Supp. 2d at 361.

[36] *See Lentell*, 396 F.3d at 166, 176 & nn.6–7, 177; *Merrill Lynch*, 273 F. Supp. 2d at 361 (discussing Merrill Lynch's "Investment Risk Rating," which, incidentally, was denoted in all of the Merrill Lynch reports under fire in these cases and ranged from "A," the lowest risk rating, to "D," the highest level).

[37] *See Lentell*, 396 F.3d at 166 & n.1; *Merrill Lynch*, 273 F. Supp. 2d at 361 (illustrating that Merrill Lynch's "Appreciation Potential" for the stocks in these cases were "*estimated* to appreciate by 20% or more within the immediately following 12 months and 10–20% for the 12 months following" the report's issuance).

[38] *Lentell*, 396 F.3d at 164.

[39] *See id.* at 164, 177; *Merrill Lynch*, 273 F. Supp. 2d at 358 ("The facts and circumstances . . . show beyond doubt that plaintiffs brought their own losses upon themselves when they knowingly spun an extremely high-risk, high-stakes wheel of fortune.").

[40] *See* Damien Cave, *Milton Pollack, Noted Federal District Judge, Dies at 97*, N.Y. TIMES, Aug. 16, 2004, at B7. Graduating from Columbia Law School in 1929, Judge Pollack was appointed to the federal bench in 1967 by President Lyndon B. Johnson and was a judge in the Southern District of New York for over thirty-six

securities litigation.[41] With his legendary wit,[42] Judge Pollack granted the defendants' pre-answer motion to dismiss[43] the "two prolix"[44] complaints pursuant to section 21D of the PSLRA[45] and Rules 12(b)(6)[46] and 9(b)[47] of the Federal Rules of Civil Procedure, while threatening, but not employing, the use of sanctions.[48] In a

years. *See id.*; *see also* Mark Hamblett, *Judge Pollack Feted on His 96th Birthday*, N.Y. L.J., Sept. 30, 2002, at 1.

A *Wall Street Journal* article relates a comical and somewhat infamous story told by Chief Judge Michael Mukasey of the Southern District of New York about Pollack's early years as a plaintiffs' lawyer. While taking a deposition from Spyros Skouras, the head of 20th Century Fox at the time, Pollack, without asking, selected and lit a cigar from Mr. Skouras's humidor. Chief Judge Mukasey explains, "Visibly reddening, Mr. Skouras said: 'Mr. Pollack, I don't remember offering you a cigar.' Mr. Pollack replied, 'Those aren't your cigars, those are the stockholders' cigars.'" Ann Davis & Randall Smith, *Judge Pollack's Investor Lectures*, WALL ST. J., July 3, 2003, at C1.

[41] In 2001, pursuant to 15 U.S.C. § 78u–4(a)(1) and Rule 8(a) of the Federal Rules of Civil Procedure, Judge Pollack dismissed yet another group of consolidated cases, which alleged violations of Rule 10(b)(5) based on false or misleading analyst reports and buy recommendations and named Morgan Stanley Dean Witter and its lead analyst Mary Meeker as defendants. *See, e.g.*, Williams v. Morgan Stanley Dean Witter & Co., No. 01 CIV. 7500(MP), 2001 WL 964010 (S.D.N.Y. Aug. 23, 2001).

[42] Furthering Mark Twain's cynical view of the market, Judge Pollack curtly admonished the plaintiff class with the following colorful quip:

> Seeking to lay the blame for the enormous Internet Bubble solely at the feet of a single actor, Merrill Lynch, plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful of lucky winners. . . . [P]laintiffs brought their own losses upon themselves when they knowingly spun an extremely high-risk, high-stakes wheel of fortune.

Merrill Lynch, 273 F. Supp. 2d at 358.

[43] *See id.* at 355; *see also* Michael Carroll, *Justice for Wall Street*, WALL ST. J., July 22, 2003, at B2 ("There are glimmers of hope for Wall Street these days. . . . [Judge Pollack's] decision may suggest a pendulum swing away from the banker bashing that has been so popular of late. . . . [and] could change the world of securities class actions as we know it.").

[44] *Merrill Lynch*, 273 F. Supp. 2d at 369 ("It has not been an easy task to comb through the two prolix and unnecessarily repetitive complaints—each of which is 68 pages in length . . . .").

[45] *See* 15 U.S.C. § 78u–4(b)(1) to (b)(2), (b)(4) (2000).

[46] FED. R. CIV. P. 12(b)(6) ("[T]he following defenses may at the option of the pleader be made by motion: . . . (6) *failure to state a claim upon which relief can be granted*.") (emphasis added).

[47] FED. R. CIV. P. 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake *shall be stated with particularity*.") (emphasis added).

[48] In alluding to the imposition of sanctions, Judge Pollack warned that the "[d]efendants have moved to strike [the complaint], and not without reasonable basis," yet "mindful of its obligation to construe pleadings so as to do substantial justice, the Court instead decided to shoulder, itself, the burden of threshing all of

thorough, forty-three page opinion, the district court dismissed the pleadings mainly for failing to adequately plead loss causation,[49] failing to plead fraud with the requisite level of particularity,[50] and failing to commence the action in a timely manner.[51]

On appeal, the circuit held that the actions were timely filed;[52] however, it affirmed the underlying dismissal "on the ground that the complaints fail[ed] to plead that the alleged misrepresentations and omissions caused the claimed losses."[53] Paying considerable attention to the "systematic and consistent risk indicator[s]" contained in these research reports,[54] *Lentell* culminates in a succinct tutorial on the Second Circuit's loss causation standard in analyst conflict cases.[55] The court's tutorial reaffirms and clarifies a line of recent circuit decisions[56]—*Emergent Capital Investment Management, LLC v.*

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the chaff in search of any kernels that might emerge from the complaints." *Merrill Lynch*, 273 F. Supp. 2d at 369–70 (citations omitted); *see also* FED. R. CIV. P. 8(a)(2) ("A pleading which sets forth a claim for relief . . . shall contain . . . (2) *a short and plain statement of the claim* showing that the pleader is entitled to relief.") (emphasis added). Rule 8 goes on to provide that "[a]ll statements shall be made subject to the obligations set forth in Rule 11." FED. R. CIV. P. 8(e)(2).

[49] *See Merrill Lynch*, 273 F. Supp. 2d at 362–68.

[50] *See id.* at 368–75.

[51] *See id.* at 382–90.

[52] *See* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 167–72 (2d Cir. 2005). "The articles cited by the district court describe the conflicted situation of Wall Street's research analysts; but evidence of the outright falsity of Merrill Lynch's investment recommendations is stray and indiscriminate at best, and is insufficient to put plaintiffs on inquiry notice of the specific frauds alleged." *Id.* at 171.

[53] *Id.* at 164.

[54] *Id.* at 176 ("In addition to this systematic and consistent risk indicator, the research reports are full of (unchallenged) analysis suggesting that 24/7 Media and Interliant were volatile investments, and therefore subject to sudden and substantial devaluation risk.") (citation omitted).

[55] *Id.* at 177. In clarifying the causation requirement applicable to analyst conflict cases, the *Lentell* court held:

> [W]here (as here) substantial indicia of the risk that materialized are unambiguously apparent on the face of the disclosures . . . a plaintiff must allege (i) facts sufficient to support an inference that it was defendant's fraud—rather than other salient factors—that proximately caused plaintiff's loss; or (ii) facts sufficient to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed an investment.

Id.

[56] The *Lentell* court emphasized that it was following the holdings of the three central Second Circuit cases, which establish collectively the circuit's analytical approach to loss causation. *See id.* at 173–74.

Stonepath Group, Inc.;[57] *Castellano v. Young & Rubicam, Inc.*;[58] and *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*[59]—while casting considerable doubt on the efficacy of one often-criticized Second Circuit decision, *Marbury Management, Inc. v. Kohn*.[60]

By clarifying the circuit's standard for pleading loss causation, *Lentell* reserved its place among the long line of prodigious Second Circuit decisions wrestling with the construction and application of the federal securities laws. Furthermore, Judge Jacobs' sound opinion reserved his place among the circuit's distinguished securities law jurists, such as Judges L. Hand, Friendly, Feinberg, Meskill, and Winter.

II. OVERVIEW OF SECURITIES ANALYSTS' CONFLICTS OF INTEREST: REGULATORY REFORM, ENSUING ENFORCEMENT EFFORTS, AND A LITANY OF LITIGATION

In the wake of the scandalous corporate debacles and the bursting of the thinly walled Internet stock bubble—even after the promulgation of tomes of disclosure-oriented regulations[61]—

[57] 343 F.3d 189 (2d Cir. 2003).

[58] 257 F.3d 171 (2d Cir. 2001).

[59] 250 F.3d 87 (2d Cir. 2001).

[60] 629 F.2d 705 (2d Cir. 1980). The *Lentell* court unambiguously called into question the precedential authority of *Marbury Management*, which it warily relegated to a clever "but see" citation and expressly failed to mention in a list of cases that the court stated it was following. *See Lentell*, 396 F.3d at 174.

[61] It was the prophetic epigram of Supreme Court Justice Louis Brandeis, made prior to his tenure on the bench, which set the tenor for the current disclosure-oriented ethos that pervades the modern securities regulations: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914). In furtherance of Brandeis's illustrative metaphor, following the Crash of 1929, the drafters of the modern securities laws patterned their regulatory philosophy on mandatory disclosure whereby, at least in principle, material information is disseminated to investors in an accurate and timely fashion. *See* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 9 (1983) (examining the arguments made by proponents of the SEC's mandatory corporate disclosure system).

Our reliance on a system of mandatory disclosure remains the subject of heated scholarly debate. Many notable, revisionist commentators question the effectiveness of mandatory disclosure as a panacea and argue that the present disclosure-based regulations produce few benefits while generating considerable costs. *See, e.g.*, George J. Benston, *An Appraisal of the Costs and Benefits of Government-Required Disclosure: SEC and FTC Requirements*, 41 LAW & CONTEMP. PROBS. 30, 32–33 (1977); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the*

Wall Street appeared more volatile than ever.[62] The allegations in *Lentell* stemmed directly from one of the many hot button topics rearing its ugly head with the implosion of the technology stock bubble: the inherent conflicts of interest under which securities research analysts operate.[63] Commentators had long

Protection of Investors, 70 VA. L. REV. 669, 672–73 (1984); Merritt B. Fox, *Rethinking Disclosure Liability in the Modern Era*, 75 WASH. U. L.Q. 903, 903–05 (1997); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUSINESS 117, 117 (1964).

Conversely, other leading commentators find that the present regulatory scheme, although far from flawless, helps to enhance the accuracy of market information and to compensate for market malfunction. *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 753 (1984); Dan Seligman, *Controversial Solution to the Problem of Stocks That Implode After Earnings Surprises: Real-Time Financial Reporting*, FORBES, Oct. 30, 2000, at 146 ("'Information is critical to the evaluation of risk. The less that is known about the current state of a market or venture, the less the ability to project future outcomes and, hence, the more those potential outcomes will be discounted.'" (quoting Federal Reserve Chairman, Alan Greenspan)).

[62] *See* Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 545 (2003) (explaining how in the 1930s there was a "need to assure against systemic collapses caused by excessive stock market speculation leading to the . . . bankruptcy of numerous financial institutions" and how a very "similar crisis of investor confidence exists today due to the bursting of the technology stock market bubble and the corporate financial scandals of Enron Corp. [and] Worldcom"); *see also* Joseph Michael Heppt, Note, *An Alternative to Throwing Stones: A Proposal for the Reform of Glass-Steagall*, 52 BROOK. L. REV. 281, 316 (1986) ("[A]lthough the modern markets include numerous securities that were unheard of in 1933, the volatile and speculative nature of the securities industry . . . remains unchanged.").

[63] The scope of this Comment cannot even begin to scratch the surface of the complex issues surrounding securities analysts' conflicts of interest. For a well-reasoned overview of securities analysts' conflicts of interests and the regulatory reforms instituted to address them, see Jill E. Fisch & Hillary A. Sale, *The Securities Analyst As Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035 (2003); Gross, *supra* note 10, at 631–32; Barbara Moses, *They Were Shocked, Shocked: The "Discovery" of Analyst Conflicts on Wall Street*, 70 BROOK. L. REV. 89 (2004); Elizabeth A. Nowicki, *A Response to Professor John Coffee: Analyst Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 72 U. CIN. L. REV. 1305 (2004); John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors*, 81 DENV. U. L. REV. 1 (2003); Karen Contoudis, Note, *Analyst Conflicts of Interests: Are the NASD and NYSE Rules Enough?*, 8 FORDHAM J. CORP. & FIN. L. 123 (2003); Robert P. Sieland, Note, Caveat Emptor! *After All the Regulatory Hoopla, Securities Analysts Remain Conflicted on Wall Street*, 2003 U. ILL. L. REV. 531 (2003).

Additionally, there was vast press coverage addressing research analysts' conflicts of interests. *See, e.g.*, John C. Coffee Jr., *Virtue and the Securities Analyst*, N.Y. L.J., July 19, 2001, at 5; Barbara Donnelly, *Tough Times for Research Directors*, WALL ST. J., May 28, 1991, at C1 ("Research directors warn that the growing pressure on research analysts to serve a firm's investment banking and other needs can lead to serious conflicts of interest. 'It's easy to compromise research in pursuit

known of the concern that sell-side research analysts issued overly optimistic recommendations of the securities on which they were reporting[64] because the analysts were significantly influenced by and wished to curry favor with their firm's investment banking arm, which in turn wanted to attract more business to the firm by having analysts issue positive recommendations of their clients.[65] In essence, the analysts did not want to bite the hand of the investment bankers that fed them by issuing less than favorable recommendations of their firm's clients. It was the existence of these cozy, symbiotic relationships between the theoretically independent research analysts and the investment banks, which paid the analysts' steep salaries, that raised many eyebrows.[66] Investor frustration influenced the political barometer, which in turn signaled a change in the regulatory sea state.

Congress responded to the hue and cry of thwarted investors and, more importantly, to voters with a rash of regulatory activism.[67] The congressional regulatory response also prompted

of corporate finance, merchant banking or internal money management.'" (quoting Barry Tarasoff, Director of Research, Wertheim Schroder & Co.)); David D. Kirkpatrick, *Coziness Gets Less Comfortable for REITs, Wall Street: Patriot American's Problems Throw Focus on Possible Conflicts of Interest*, WALL ST. J., Nov. 19, 1998, at B10 ("[P]otential conflicts are common on Wall Street. . . . Securities analysts who work for investment banks seek to advise investors about stocks but often have pay packages tied to their own firm's income from underwriting clients."); Roger Lowenstein, *Today's Analyst Often Wears Two Hats*, WALL ST. J., May 2, 1996, at C1 ("'The recommendations by underwriter analysts show significant evidence of bias and possible conflict of interest.'") (quoting from a study conducted by Roni Michaely and Kent L. Womack on the objectivity of underwriters); *The Trader's Lament*, ECONOMIST, Oct. 16, 1999, at 73 ("[A]nalysts' conflicts of interest, already sharp, will become sharper still. For all the claims that an analyst's worth lies in investors' perceptions of his independence, few are ever brave enough to put out a sell recommendation on a firm with which their bank does investment-banking business.").

[64] *See* Richard A. Rosen, *Liability for Optimistic Research Reports Prepared by Securities Analysts*, INSIGHTS, April 2002, at 9 ("The media has pointed to various statistics that allegedly show that, while the [Nasdaq] composite index was dropping by 60 percent, less than one percent of analysts' recommendations were to 'sell.'").

[65] *See* Moses, *supra* note 63, at 90 ("No securities regulator should have been shocked to discover that sell-side equity analysts were joined at the hip to their investment banking colleagues and that the objectivity of their research suffered as a result.").

[66] *See id.* at 89–90; *see also supra* note 63 and accompanying text.

[67] President George W. Bush signed the Sarbanes-Oxley Act of 2002 into law on July 30, 2002. *See* Pub L. No. 107–204, 116 Stat. 745 (codified as amended at various sections of 11, 15, 18, 25, 28, and 29 U.S.C.). Sarbanes-Oxley mandated additional disclosure-based regulations as a means of bolstering investor confidence in the

actions from the self-regulatory organizations (SROs),[68] such as the New York Stock Exchange (NYSE)[69] and the National Association of Securities Dealers (NASD).[70]

In accord with the ensuing rush of regulatory reform to address these conflicts of interest, New York State Attorney General Eliot Spitzer[71] answered the cries of disenchanted

market and protecting "investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws." *Id.* § 1, 116 Stat. at 745.

In response to the concern over analysts' conflicts of interest, Title V of Sarbanes-Oxley amended the Exchange Act with the addition of section 15D, which required the adoption of "rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information." *Id.* § 501, 116 Stat. at 791 (codified as amended at 15 U.S.C. § 78o-6(a)).

[68] Section 3(a)(26) of the Exchange Act defines the term "self-regulatory organization." *See* 15 U.S.C. § 78c(a)(26) (2000). Self-regulatory organizations, such as the NYSE and NASD, are authorized pursuant to sections 6, 15A, 19, and 23 of the Exchange Act to institute their own rules and regulations governing the operation of their respective exchanges. *See id.* §§ 78f, 78o–3, 78s, 78w; *see also* 3 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 1:198 (2d ed. 2004) (discussing the NYSE and NASD reaction to problem with conflicted securities analysts). *But see* Contoudis, *supra* note 63, at 148 (positing that these new analyst rules may be ineffective to address the scope of the problem); Sieland, *supra* note 63, at 566–69 ("The new NASD and NYSE Rules, overall, strike an appropriate balance between protecting investors and protecting the viability of the analyst profession—but they are not the ideal.").

[69] The NYSE filed with the SEC amendments to NYSE Rule 472, Communications with the Public, as a means of addressing analyst conflicts of interest with stock exchange members by requiring the mandatory disclosure of such conflicts and instituting rules to minimize analyst conflicts. *See* Self Regulatory Organizations; Order Approving Proposed Rule Changes By the New York Stock Exchange, Inc. Relating to Exchange Rules 344, 345A, 351 and 472 and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change by the New York Stock Exchange, Inc. and Amendment No. 3 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest, 68 Fed. Reg. 45,875 (Aug. 4, 2003).

[70] The NASD also filed with the Commission NASD Rule 2711, Research Analyst and Research Reports, a much broader and more comprehensive analyst conflict regulation. *See id.* This new rule amended and superseded the existing NASD Rule 2210, Communications with the Public. *See id.*

[71] Although lacking the infamy of Aaron Burr, Eliot Spitzer is arguably one of New York's most proactive and aggressive Attorneys General. For an interesting historical perspective of the Office of the New York Attorney General, see Philip Weinberg, *Office of N.Y. Attorney General Sets Pace for Others Nationwide*, N.Y. ST. B.J., June 2004, at 10. "'The behavior of competitors in a free market must be guided by a government that defines boundaries of ethics, fair dealing and disclosure. . . . It is our obligation to find that boundary line to preserve the free market.'" John

investors by making application under the archaic Martin Act[72] for an ex parte order enjoining Merrill Lynch from issuing analyst reports and ordering certain disclosures.[73] The ensuing investigation and disclosure demands resulted in a $100 million settlement by Merrill Lynch.[74] With the scent of blood in the air, Spitzer also sounded the charge in a cooperative effort with the Securities and Exchange Commission (SEC), investigating analyst practices at ten leading Wall Street firms.[75] This joint enforcement action yielded a settlement award of $1.4 billion, and drafted a blueprint for shoring the firms' defunct "Chinese walls"[76] and for patching the sizeable cracks that undermined the

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Caher, *Market Needs Rules, Spitzer Tells State Bar*, N.Y. L.J., Jan. 27, 2005, at 1 (quoting Eliot Spitzer during his acceptance speech for the Stanley H. Fuld Award given to him by the New York State Bar Association on Commercial and Federal Litigation).

[72] N.Y. GEN. BUS. LAW §§ 352, 354 (McKinney 1996). Codified in 1909, the Martin Act is a New York State blue-sky law, which defines securities fraud in far broader terms than the federal securities laws thus providing the New York State Attorney General with an expansively liberal arsenal of securities fraud investigative and prosecutorial authority. *See id.*

[73] *See* Aff. in Supp. of Application for an Order Pursuant to General Business Law Section 354 at 2–3, *In re* Inquiry by Eliot Spitzer (N.Y. Sup. Ct. Apr. 8, 2002) (No. 02-401522), *available at* http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf [hereinafter Dinallo Affidavit]; Order Pursuant to General Business Law Section 354, *In re* Inquiry by Eliot Spitzer at 1–2 (N.Y. Sup. Ct. Apr. 8, 2002) (No. 02-401522), *available at* http://www.oag.state.ny.us/press/2002/apr/apr08b_02_attach.pdf; *see also* Kip Betz & Rachel McTague, *Broker Dealers: N.Y. Court Stays Order Requiring Merrill Lynch To Disclose Rating Systems*, 34 SEC. REG. & L. REP. (BNA) 610 (Apr. 15, 2002).

[74] This Martin Act inquiry resulted in a $100 million settlement agreement and a pact implementing the overhaul of Merrill Lynch's flawed analyst screening procedures. *See* Agreement Between the Att'y General of the State of New York and Merrill Lynch, Pierce, Fenner & Smith, Inc. (May 21, 2002), *available at* http://www.oag.state.ny.us/investors/ merrill_agreement.pdf; Press Release, OFFICE OF N.Y. STATE ATT'Y GEN. ELIOT SPITZER, Spitzer, Merrill Lynch Reach Unprecedented Agreement To Reform Investment Practices (May 21, 2002), *available at* http://www.oag.state.ny.us/press/2002/may/may21a_02.html.

[75] *See* Phyllis Diamond et al., *Broker Dealers: Wall St. Agrees to $1.4 Billion Payment, Broad Reforms, Resolving Conflict Changes*, 34 SEC. REG. & L. REP. (BNA) 2037 (Dec. 23, 2002); Press Release, OFFICE OF N.Y. STATE ATT'Y GEN. ELIOT SPITZER, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement To Reform Investment Practices (Dec. 20, 2002), *available at* http://www.oag.state.ny.us/press/2002/ dec/dec20b_02.html; Att'y Gen. Eliot Spitzer, Statement Regarding the "Global Resolution" of Wall Street Investigations (Apr. 28, 2003), *available at* http://www.oag.state.ny.us/press/ statements/global_resolution.html.

[76] Investment firms that both advise clients and underwrite securities utilize what have come to be known as "Chinese walls" or internal, written procedures designed to insulate the analysts from underwriters in order to prevent, or at least

systems that theoretically insulated research analysts from the objectivity-defeating effect of underwriter oversight.[77]

Eliot Spitzer's adept wielding of the enforcement sword led many investors, or rather their class action lawyers, to file federal securities fraud complaints similar to those in *Lentell*.[78] The gravamen of the allegations in *Lentell* was based substantially, if not entirely, on Eliot Spitzer's probe into analyst practices at Merrill Lynch.[79] As such, the *Lentell* plaintiffs claimed "that the analyst opinions expressed in the research reports were materially misleading,"[80] and that "the analysts misrepresented their true opinions in the reports . . . and did not disclose certain alleged conflicts of interest within the Merrill Lynch brokerage house."[81]

Although setting forth egregious behavior by Merrill Lynch's analysts, their complaints failed to satisfy the Second Circuit's interpretation of the PSLRA's requirements for adequately pleading actionable securities fraud.[82] The following section details the stringent pleading standards—ultimately clarified by *Lentell*—that are applicable in the torrent of analysts' conflicts cases filed in federal court.

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limit, conflicts of interest. *See generally* Martin Lipton & Robert B. Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459, 459 (1975) (recommending a "reinforced Chinese Wall—strengthened in certain situations to prevent abuse; flexible in others to preserve market liquidity; adaptable in every instance").

[77] *See* Diamond et al., *supra* note 75, at 2037.

[78] *See* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 164–65 (2d Cir. 2005) ("Within weeks, some 140 class-action complaints were filed, relying on the NYAG's application to allege securities fraud in connection with Merrill Lynch's analyses and investment recommendations. . . ."); *see also* Susanne Craig, *Wall Street Braces for Bad-Research Claims*, WALL ST. J., Jan. 14, 2003, at C1 (stating that a "barrage" of private, class-action litigation has been spurred by a recent $1.4 billion settlement Wall Street firms made with securities regulators); Brooke A. Masters & Ben White, *Wall St. Facing Legal Blitz; 'Global' Settlement Prompts Investor to File Claims*, WASH. POST, July 3, 2003, at E1 ("Regulators said earlier this year that the details released in the Wall Street settlement could serve as a road map for shareholders wishing to pursue lawsuits.").

[79] *See Lentell*, 396 F.3d at 164; *In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 359 (S.D.N.Y. 2003) ("In support of the fraud allegations, plaintiffs rely almost exclusively on, and quote heavily from, an affidavit . . . [detailing] the efforts of the New York Attorney General to investigate defendants' internet research group.").

[80] *See Lentell*, 396 F.3d at 164; *Merrill Lynch*, 273 F. Supp. 2d at 359.

[81] *See Lentell*, 396 F.3d at 164; *Merrill Lynch*, 273 F. Supp. 2d at 360.

[82] *Lentell*, 396 F.3d at 169 ("[S]uch pleading does not suffice to plead federal securities fraud.").

III. THE *LENTELL* COURT REINVIGORATES AND CLARIFIES THE SECOND CIRCUIT'S REQUIREMENTS FOR TRIGGERING INQUIRY NOTICE AND PLEADING LOSS CAUSATION UNDER THE PSLRA

In a legislative attempt to reduce the number of frivolous securities fraud cases and strike suits brought in federal court, Congress proposed instituting considerable statutory hurdles for plaintiff classes seeking relief under the securities laws' antifraud provisions.[83] Congress's grand design came to fruition with the passage of the PSLRA.[84] This amendment to the Exchange Act advanced Congress's assault on strike suits by placing the following Herculean requirements on plaintiffs pleading a cause of action under section 10(b) and Rule 10b–5:[85] (1) a plaintiff must specify each allegedly false statement or omission with particularity;[86] (2) a plaintiff must plead and prove

[83] *See* H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 730 (stating there was "significant evidence" that litigation based on the antifraud provisions of the securities laws had been "undermined by . . . abusive and meritless suits . . . whenever there is a significant change in an issuer's stock price"); S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683 (discussing that Congress's intention for drafting the PSLRA was "to lower the cost of raising capital by combatting [litigation] abuses, while maintaining the incentive for bringing meritorious actions").

For an engaging discussion of the legislative process leading up to the passage of the PSLRA, see Avery, *supra* note 20, at 336 (stating that although Congress's original concern was with the "explosion of meritless securities lawsuits, particularly class actions, filed solely for their settlement value," the Reform Act "extends far beyond frivolous litigation," including "measures that significantly alter the treatment of meritorious claims, as well as frivolous ones").

[84] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.); *see also* Charles T. Williams, III, Comment, Semerenko v. Cendant Corp*: Has the Time Come To Prune the "Judicial Oak"?*, 27 DEL. J. CORP. L. 587, 591 (2002) ("With the passage of the PSLRA in 1995, Congress reinforced a restrictive interpretation of Rule 10b-5.").

[85] In broad terms, in order "[t]o state a cause of action under section 10(b) and Rule 10b-5, a plaintiff must plead that the defendant made a false statement or omitted a material fact, with scienter, and that plaintiff's reliance on defendant's action caused plaintiff injury." Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001) (quoting San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801, 808 (2d Cir. 1996)); *see also, e.g.*, *In re* IBM Corp. Sec. Litig., 163 F.3d 102, 106 (2d Cir. 1998) (outlining the requirements for stating a claim under section 10(b) and Rule 10b-5).

[86] *See* 15 U.S.C. § 78u–4(b)(1) (2000). This section of the PSLRA is entitled "Misleading Statements and Omissions" and it provides:

> In any private action arising under this chapter in which the plaintiff alleges that the defendant—
>
> (A) made an untrue statement of a material fact; or
>
> (B) omitted to state a material fact necessary in order to make the

that the defendant acted with the requisite state of mind;[87] and (3) a plaintiff must plead and prove "loss causation."[88] In addition to these arduous pleading obstacles, plaintiffs must contend with the brusque statute of limitations for section 10(b) and Rule 10b–5 claims.[89]

> statements made, in the light of the circumstances in which they were made, not misleading;
>
> the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, *the complaint shall state with particularity all facts on which that belief is formed*.

Id. (emphasis added); *see* Acito v. IMCERA Group, Inc., 47 F.3d 47, 51 (2d Cir. 1995) ("We have stated that 'the complaint must: (1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent.'"(quoting Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir.1993))).

[87] *See* 15 U.S.C. § 78u–4(b)(2) (providing that "[i]n any private action arising under this chapter . . . with respect to each act or omission alleged to violate this chapter, [the complaint must] state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

The requisite state of mind is scienter, which is an "intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). A plaintiff must establish intent "either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." Novak v. Kasaks, 216 F.3d 300, 307 (2d Cir. 2000) (quoting *Acito*, 47 F.3d at 52 (quoting Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994))); *see also IBM Corp. Sec. Litig.*, 163 F.3d at 107 (addressing that a statement of opinion may be actionable only if it is "supported by specific statements of fact [that are false], or if the speaker does not genuinely or reasonably believe them").

[88] *See* 15 U.S.C. § 78u–4(b)(4) (providing that "[i]n any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter *caused the loss* for which the plaintiff seeks to recover damages") (emphasis added); *see also* Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357, 358 (1991) (discussing the Second Circuit's original definition of loss causation in *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974)).

[89] The Supreme Court in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), borrowed the one-year limitations period from section 9(e) of the Exchange Act to claims brought under section 10(b) and Rule 10b-5, even though neither of those provisions originally contained an express statute of limitations. *See id.* at 364. Section 9(e) of the Exchange Act states in relevant part that "[n]o action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation." 15 U.S.C. § 78i(e). After the August 29, 2002 effective date of the Sarbanes-Oxley Act, the statute of limitations was increased to two years after discovery and to five years after the violation. *See* Pub. L. No. 107-204, § 804, 116 Stat. 745, 801 (amending 28 U.S.C. §

The circuit's decision in *Lentell* alleviated much of the academic, judicial, and practicing bar's debate over two critical elements of the PSLRA: the requirements for triggering the inquiry notice provision of the statute of limitations[90] and the requisite standard for pleading and proving loss causation in analyst conflict cases.[91] The *Lentell* court's careful analysis of these statutory provisions will hopefully obviate future confusion surrounding their application, not only in the Second Circuit but, moreover, in the various district and circuit courts where *Lentell*'s highly persuasive doctrinal guidance merges with the Supreme Court's recent loss causation pronouncement in *Dura Pharmaceuticals*. [92]

A. *Inquiry Notice:* Lentell *Reaffirms that Non-Detailed "Storm Warnings" Are Insufficient To Trigger the Inquiry Notice Provision of the Statute of Limitations*

One of the decisive issues on appeal in *Lentell* was whether the plaintiffs' claims—irrespective of the heightened pleading requirements mandated by the PSLRA—were time-barred under the judicially imposed, one-year statute of limitations.[93] The question on appeal focused on whether the plaintiffs were placed on inquiry notice of their fraud claims by the plethora of "judicially-noticeable"[94] press coverage concerning analyst

1658).

[90] *See* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 168–72 (2d Cir. 2005).

[91] *See id.* at 172–78.

[92] The split in the circuits over the proper loss caution standard led the Supreme Court, under advisement from the Solicitor General, to grant certiorari in *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, 938 (9th Cir. 2003), *cert. granted*, 124 S. Ct. 2904 (2004). *See* Neil M. Gorsuch & Paul B. Matey, *No Loss, No Gain: The Supreme Court Should Make Clear That Securities Fraud Claims Can't Dodge the Element of Causation*, LEGAL TIMES, Jan. 31, 2005, at 52. Justice Breyer, delivering the unanimous opinion of the Court in *Dura Pharmaceuticals*, squarely disagreed with the Ninth Circuit's artificial price inflation theory, hence quelling the circuit split over the fundamental loss causation requirement. *See* Dura Pharms., Inc. v. Broudo, No. 03-932, 2005 WL 885109 (U.S. April 19, 2005), at *1, 125 S. Ct. 1627 (2005).

[93] *See Lentell*, 396 F.3d at 167–72; *In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 378–90 (S.D.N.Y. 2003) (containing the lower court's analysis of the inquiry notice prong under the statute of limitations).

[94] *Merrill Lynch*, 273 F. Supp. 2d at 382, 383 n.3 ("[O]n a motion to dismiss, a court may consider . . . 'matters as to which judicial notice may be taken. . . .'" (alteration in original) (quoting Chambers v. Time Warner, Inc., 282 F.3d 147, 153 (2d Cir. 2002) (quoting Brass v Am. Film Techs., Inc., 987 F.2d 142, 150 (2d Cir. 1993))).

conflicts of interest.[95] In a painstakingly detailed analysis, the circuit found that the plaintiffs were not placed on inquiry notice of their fraud claims based on generalized, industry-wide "storm warnings" of analyst conflicts reported by the financial press.[96] The *Lentell* court held that more particularized detail, such as issuer-specific data, was required for triggering inquiry notice, but the court cautiously left the requisite level of specificity and detail mostly undefined.[97]

Although the antifraud provisions did not originally contain an express statute of limitations, the Supreme Court incorporated by reference a one-year statute of limitations to claims brought under section 10(b) and Rule 10b-5 of the Exchange Act.[98] The Court borrowed the statute of limitations from section 9(e) of the Exchange Act.[99] A plaintiff triggered this brief, one-year statute of limitations by either "obtain[ing] actual knowledge of the facts giving rise to the action,"[100] or by being placed on inquiry notice such that "in the exercise of reasonable diligence, [the plaintiff] should have discovered the facts underlying the alleged fraud."[101]

As in most securities fraud cases, the application of the

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[95] *See Lentell*, 396 F.3d at 167–72.

[96] *See id.* at 170.

> Conflicts of interest present opportunities for fraud, but they do not, standing alone, evidence fraud . . . . Nor does the existence of temptation trigger a duty of inquiry—at least, not by a reasonable investor. Something more than conflicted interest is required, no matter how well publicized the conflict may be.

Id.

[97] *See id.* at 169; *see also* Flumenbaum & Karp, *supra* note 19.

[98] *See* Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 364 (1991).

[99] *See id.* at 364 n.9.

[100] LC Capital Partners, LP v. Frontier Ins. Group, Inc., 318 F.3d 148, 154 (2d Cir. 2003) (quoting Kahn v. Kohlberg, Kravis, Roberts & Co., 970 F.2d 1030, 1042 (2d Cir. 1992)).

[101] Rothman v. Gregor, 220 F.3d 81, 97 (2d Cir. 2000) (quoting Sterlin v. Biomune Sys., 154 F.3d 1191, 1201 (10th Cir. 1998)); *see also* Newman v. Warnaco Group, Inc., 335 F.3d 187, 193 (2d Cir. 2003) ("'[W]hen the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded, a duty of inquiry arises . . . .'" (quoting Dodds v. Cigna Sec., Inc., 12 F.3d 346, 350 (2d Cir. 1993))); *LC Capital Partners*, 318 F.3d at 155 (stating that courts will look to public information, such as the financial press or other news sources, to see if the plaintiff was on inquiry notice of its claims); *Dodds*, 12 F.3d at 350 (noting that the statute of limitations is triggered "when a reasonable investor of ordinary intelligence would have discovered the existence of the fraud").

inquiry notice provision was implicated in *Lentell*.[102] Courts within the Second Circuit ran the gamut as to what they deemed to be sufficient inquiry notice to commence running of the statute of limitations.[103] The resulting confusion was alleviated, in part, by a series of Second Circuit decisions establishing some consensus on the appropriate level of "notice."[104] In the lower court's opinion, however, Judge Pollack found that the *Lentell* plaintiffs' complaints were time-barred based on the extensive amount of press coverage that analyst conflicts of interest received in the financial press.[105] The plaintiffs moved for reconsideration of the district court's dismissal on statute of limitations grounds in light of an influential Second Circuit decision, *Newman v. Warnaco Group, Inc.*,[106] which was reported

[102] *See Lentell*, 396 F.3d at 168 ("[W]e can readily resolve the issue [of inquiry notice] on a motion to dismiss, and have done so in 'a vast number of cases.'" (citing *LC Capital Partners*, 318 F.3d at 156 (quoting *Dodds*, 12 F.3d at 352 n.3)).

[103] There are many examples demonstrating how some courts within the Second Circuit have recently, as well as historically, applied the inquiry notice provision. *See, e.g.*, Levitt v. Bear Stearns & Co., 340 F.3d 94, 102–04 (2d Cir. 2003) (finding that plaintiffs were not placed on inquiry notice based on a complaint filed in federal court in Texas or the statement of claim filed in an NASD arbitration); *Newman*, 335 F.3d at 193–94 (finding that the plaintiffs were not placed on inquiry notice by defendant's filing of a revised Form 10-K); *LC Capital Partners*, 318 F.3d at 155 (finding that adequate "storm warnings" did exist based on reports of substantial reserve problems and pending litigation in the Eastern District of New York); *In re* Ames Dep't Stores, Inc. Note Litig., 991 F.2d 968, 979–81 (2d Cir. 1993) (finding that the statute of limitations was not triggered for debt-security holders by press coverage of concerns over the company's equity securities); *In re* Initial Pub. Offering Sec. Litig., 341 F. Supp. 2d 328, 347–49 (S.D.N.Y. 2004) (finding that press reports of IPO pricing concerns did not place the plaintiffs on inquiry notice); Fogarazzo v. Lehman Bros., Inc., 341 F. Supp. 2d 274, 299–300 (S.D.N.Y. 2004) (finding that media reports of analyst conflicts of interest did not give rise to inquiry notice); *In re* Worldcom, Inc. Sec. Litig., 294 F. Supp. 2d 431, 447–48 (S.D.N.Y. 2003) (finding that press releases of possible corporate fraud did not constitute storm warning sufficient to give rise to the duty of inquiry); *In re* Executive Telecard, Ltd. Sec. Litig., 913 F. Supp. 280, 285 (S.D.N.Y. 1996) (finding that information contained in public SEC filings did not put the plaintiffs on inquiry notice of the falsity of audited financial statements); Westinghouse Elec. Corp. v. '21' Int'l Holdings, Inc., 821 F. Supp. 212, 222–23 (S.D.N.Y. 1993) (finding that analyst reports placed the plaintiffs on inquiry notice of a looming corporate write-off).

[104] *See, e.g.*, *Levitt*, 340 F.3d at 101; *Newman*, 335 F.3d at 193.

[105] *See In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 378–90 (S.D.N.Y. 2003) (squaring its statute of limitations dismissal on the standard applied in *LC Capital Partners,* 318 F.3d at 153–55, as well as other Southern District of New York decisions, in which plaintiffs' complaints were dismissed as time-barred based on inquiry notice of "potential fraud").

[106] 335 F.3d at 194 (holding that the plaintiffs were not placed on inquiry notice of possible fraud by the defendant based on the defendant's filing of a revised annual

after Judge Pollack rendered his initial decision.[107] Yet again, the district court relied on the extensive, although non-stock specific, press coverage of industry-wide analyst conflicts of interest in support of its conclusion that the plaintiffs were placed on inquiry notice of their fraud claims; hence, the district court denied reconsideration of its dismissal on statute of limitations grounds.[108]

The panel in *Lentell*, reversing on the statute of limitations grounds, was unwilling to extend the inquiry notice provision with the same breadth that the district court felt was proper.[109] Notably, the circuit followed the straightforward analysis employed in *Newman* and *Levitt v. Bear Stearns & Co.*,[110] which tempered the reach of inquiry notice to only instances where the data "'relates *directly* to the misrepresentations and omissions' that plaintiffs allege against Merrill Lynch."[111] The circuit remarked that the scores of articles cited by the district court in support of its conclusion that inquiry notice was established did not specifically mention either of the Internet companies at issue in *Lentell*.[112] The circuit found it unreasonable to hold that the one-year statute of limitations was triggered for every company recommended in a Merrill Lynch report by press releases generally discussing analysts' conflicts at Merrill Lynch.[113] The

SEC report, Form 10-K).

[107] In an attempt to counteract the influence of the recent Second Circuit decision in *Newman*, and in response to plaintiffs' motion for reconsideration under Rule 59(e) of the Federal Rules of Civil Procedure, Judge Pollack cited numerous press releases spanning the panoply of press coverage on the issue of analysts' conflicts of interest, including the *Wall Street Journal*, *Boston Globe*, *Business Week*, *Crain's New York Business*, *The Economist*, *Fortune*, and *The Washington Post*. *See Merrill Lynch*, 273 F. Supp. 2d at 383–88.

[108] *See id.* at 389–90, 394.

[109] *See* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 170 (2d Cir. 2005) ("The articles relied upon to support that [inquiry notice was triggered] fall well short of the specificity required to prompt further inquiry by a reasonable investor.").

[110] 340 F.3d 94, 102–04 (2d Cir. 2003) (holding that plaintiffs were not placed on inquiry notice based on a complaint filed in federal court in Texas or the statement of claim filed in an NASD arbitration); *Newman*, 335 F.3d at 193–94 (finding that the plaintiffs were not placed on inquiry notice by the defendant's filing of a revised Form 10-K).

[111] *See Lentell*, 396 F.3d at 169 (alteration in original) (quoting *Newman,* 335 F.3d at 193); *see also* Flumenbaum & Karp, *supra* note 19.

[112] *See Lentell*, 396 F.3d at 171 ("However, [the article] says nothing about 24/7 Media or Interliant; neither company is mentioned in *any* article relied upon by the district court.").

[113] *See id.*

race to timely file securities fraud complaints would occur at the expense of "the level of particularity in pleading required by the PSLRA,"[114] thus thwarting Congress's intent behind drafting the PSLRA.[115] *Lentell* also cautioned that since much of the information relied on in the complaints was discovered as a result of Eliot Spitzer's investigation, the court would not "'punish [a] pleader for waiting until the appropriate factual information [has been] gathered by dismissing the complaint as time-barred.'"[116]

By clearing away much of the fog that surrounded prior courts' application of inquiry notice, it is submitted that the *Lentell* court reinserted the oft-missing variables of reasonableness[117] and fact-specific inquiry[118] back into the inquiry notice equation. Generalized "storm warnings," no matter how prolific, on sweeping, market-wide issues like analysts' conflicts of interests do not place the reasonable investor on inquiry notice of specific instances of securities fraud in the companies in which they hold stock.[119] The circuit held that issuer-specific detail is necessary. But what quantum of detail is required?

Regrettably, the *Lentell* panel skirted this question, providing little guidance on the extent to which the information must be directly related to the alleged fraud before the inquiry notice provision is triggered.[120] By warily leaving this follow-up question open-ended, practitioners will inevitably seek further instruction from the bench.[121] It seems axiomatic, however, to suggest that each instance of purported securities fraud requires a thorough, fact-specific examination by both counsel and the court to see if inquiry notice was implicated. Yet, this Comment suggests that this seemingly obvious approach is exactly what the *Lentell* court suggests. *Lentell* did not impart an inflexible,

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[114] *Id.*

[115] *See id.*

[116] *Id.* (alteration in original) (quoting Levitt v. Bear Stearns & Co., Inc., 340 F.3d 94, 104 (2d Cir. 2003)).

[117] *See* Dodds v. Cigna Sec., Inc., 12 F.3d 346, 350 (2d Cir. 1993) (stating that the inquiry notice standard is based on the objective standard of when a reasonable investor of ordinary intelligence would have discovered the existence of the fraud).

[118] *See Levitt*, 340 F.3d at 102–04 (requiring that courts engage in a fact-specific inquiry when examining whether a plaintiff "could have" learned of the facts giving rise to the alleged fraud).

[119] *See id.*; Newman v. Warnaco Group, Inc., 335 F.3d 187, 194 (2d Cir. 2003).

[120] *See* Flumenbaum & Karp, *supra* note 19.

[121] *See id.*

bright line rule on inquiry notice. Rather, it provided yet another example, albeit a persuasive one, of facts and circumstances surrounding a typical conflicted analyst case that did not satisfy the inquiry notice threshold.

The Second Circuit, via the progeny of decisions following *Newman*, insists that district courts conduct a careful, fact-specific examination of the available information to see if inquiry notice was implicated by way of particularized, issuer-specific data that would place a reasonable investor on inquiry notice of potential securities fraud.[122] This Comment posits that *Lentell* made one of the sizable barriers that Congress erected under the PSLRA—the inquiry notice trigger to the statute of limitations—appear surmountable for similarly situated plaintiffs. Consequently, securities fraud plaintiffs could breathe a sigh of relief—well, at least until they encountered the next arduous hurdle: loss causation.

B. Loss Causation: Lentell *Clarifies the Second Circuit's Stringent Standard for Adequately Pleading Loss Causation Under the PSLRA*

The second, and more influential, issue on appeal dealt with the hotly contested topic of loss causation.[123] The question on appeal essentially turned on whether the pleadings established that the alleged misrepresentations or omissions—Merrill Lynch's failure to disclose its analysts' conflicts of interest—caused the losses suffered by the plaintiffs.[124] In holding that the pleadings did not pass muster under the Second Circuit's

[122] *See* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 170–72 (2d Cir. 2005).

[123] *See id.* at 172–78. The standard for pleading loss causation was the subject of a feverously debated circuit split. *See* Joseph M. McLaughlin, *Directors' and Officers' Liability; What Is at Stake in 'Dura'*, N.Y. L.J., Oct. 14, 2004, at 5. As a result of the split, the Supreme Court granted certiorari in a Ninth Circuit case, *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir. 2003), *cert. granted*, 124 S. Ct. 2904 (2004), to consider whether plaintiffs "must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price." McLaughlin, *supra*, at 5.

As predicted by Mr. McLaughlin, as well as many other leading securities law scholars, the Supreme Court disagreed with the Eighth and Ninth Circuit's artificial price inflation theory, siding instead with the Second, Third, Seventh, and Eleventh Circuit's requirement for a causal link between the fraud and the drop in price. *See* Dura Pharms., Inc. v. Broudo, No. 03-932, 2005 WL 885109 (U.S. April 19, 2005), at *1, 125 S. Ct. 1627 (2005).

[124] *See Lentell*, 396 F.3d at 172.

precedents narrowly interpreting the PSLRA's loss causation provision, the *Lentell* court clarified many of its prior, less than lucid, opinions dealing with loss causation[125] and, perhaps implicitly, negated the efficacy of a questionable earlier decision, *Marbury Management*.[126] Simultaneously, the circuit raised the pleading bar in analyst conflicts cases to the level originally intended by Congress.[127] Arguably, *Lentell*'s reasoning on the issue of loss causation will receive far more scholarly criticism than its guidance on inquiry notice. It is submitted, however, that Judge Jacobs' sound loss causation analysis in *Lentell*, although not cited by the Court, served as one of the jurisprudential guideposts utilized by the Supreme Court in the much-anticipated *Dura Pharmaceuticals v. Broudo* decision.[128]

The indispensable element of causation under the federal securities laws was judge-made[129] and was principally bottomed in tort law theory.[130] As a pioneer in the realm of securities

[125] *See* Flumenbaum & Karp, *supra* note 19 ("In *Lentell*, the court rationalized and clarified its loss causation jurisprudence—which had been, in the court's own words, 'somewhat inconsistent' . . . . Much of the confusion that has long been associated with loss causation was stripped away by the court's forceful and unvarnished opinion in *Lentell*.").

[126] 629 F.2d 705 (2d Cir. 1980). The circuit unambiguously called into question the precedential authority of the often-criticized decision of *Marbury Management*, which it warily relegated to a clever "but see" citation and expressly failed to mention the case in a list of cases that the *Lentell* court stated it was following. *See Lentell*, 396 F.3d at 174; *see also* Flumenbaum & Karp, *supra* note 19 ("The court also appeared implicitly to overrule the long-controversial 1980 opinion in *Marbury Management, Inc. v. Kohn*, dismissing it with a 'but see' citation at the end of its analysis . . . .").

[127] *See* Flumenbaum & Karp, *supra* note 19 (arguing that the *Lentell* court "established a formidable barrier to pleading a claim based on alleged research analyst conflicts of interest and securities fraud claims generally").

[128] 339 F.3d 933 (9th Cir. 2003), *rev'd*, Dura Pharms., Inc. v. Broudo, No. 03-932, 2005 WL 885109 (U.S. April 19, 2005), at *1, 125 S. Ct. 1627 (2005).

[129] *See* Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974). One article pinpoints the origination of the well-known terms "transaction causation" and "loss causation" to a Note in the *Yale Law Journal*. *See* Jay W. Eisenhofer et al., *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward A Corporate Finance-Based Theory of Loss Causation*, 59 BUS. LAW. 1419, 1429 n.52 (2004) (citing Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 YALE L.J. 107, 117 (1970)).

[130] *See* Escoffery, *supra* note 20, at 1793 & n.115, 1794 n.128 (illustrating how persuasively tort law concepts and the "notions of common law fraud" have affected the antifraud provisions of section 10(b) and Rule 10b–5); *see also* Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96, 96 (1985) (explaining that "litigation under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 is at

litigation, the Second Circuit was first to establish that plaintiffs must plead and prove two separate, yet related, causation elements: transaction causation and loss causation.[131] Transaction causation, or "but for" causation in fact, can be equated to the common law fraud concept of reliance,[132] while loss causation, the far more subtle stepchild of causation, is arguably analogous to the tort concept of proximate or legal causation.[133] Judge Winter's dissent in *AUSA Life Insurance Co. v. Ernst and Young*[134]—which draws largely from Cardozo's famed proximate causation characterization of the "zone of danger"—demonstrates just how illustratively ingrained tort law concepts have become in the Second Circuit's approach to causation, especially loss causation.[135]

To establish transaction causation, a plaintiff must show that but for the defendant's alleged fraud, she would not have

present riddled with tort law doctrines").

[131] *See Schlick*, 507 F.2d at 380; *see also* Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 95 (2d Cir. 2001) ("It is settled that causation under federal securities laws is two-pronged: a plaintiff must allege both transaction causation . . . and loss causation . . . .").

[132] *See* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005) ("Transaction causation is akin to reliance, and requires only an allegation that 'but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction.'" (quoting Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 197 (2d Cir. 2003))).

[133] The Fifth Circuit decision of *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983), is credited for first expounding on the current requirements for loss causation by holding that "[t]he causation requirement is satisfied . . . only if the misrepresentation touches upon the reasons for the investment's decline in value." *Id.* at 549. Loss causation is defined as "the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." *Emergent Capital*, 343 F.3d at 197; *see Lentell*, 396 F.3d at 172–73 ("We have described loss causation in terms of the tort-law concept of proximate cause, *i.e.*, 'that the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material omission,' but the tort analogy is imperfect.") (citations omitted). *But see* Michael J. Kaufman, *supra* note 88, at 358–59 (arguing that loss causation has led to courts denying plaintiffs any damages when they cannot prove that the defendants' conduct caused all of their losses).

[134] 206 F.3d 202 (2d Cir. 2000).

[135] *See id.* at 235 (Winter, J., dissenting). In his dissent, Chief Judge Winter wrote the following:

> If the significance of the truth is such as to cause a reasonable investor to consider seriously a zone of risk that would be perceived as remote or highly unlikely by one believing the fraud, and the loss ultimately suffered is within that zone, then a misrepresentation or omission as to that information may be deemed a foreseeable or proximate cause of the loss.

Id.

bought the security in question.[136] A rebuttable presumption of transaction causation can be established using the fraud on the market theory advanced in the watershed securities case *Basic Inc. v. Levinson*.[137] Transaction causation, however, is merely one part of the causation puzzle. A successful plaintiff must also establish the more obscure loss causation element by illustrating "the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff."[138] The loss causation requirement attempts to "'fix a legal limit on a person's responsibility, even for wrongful acts.'"[139] Many plaintiffs, like those in *Lentell*, bound over the transaction causation prong[140] just to founder on the unforgiving rocks of this nebulous loss

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[136] *See Emergent Capital*, 343 F.3d at 197 ("[B]ut for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction.").

[137] 485 U.S. 224 (1988).

> "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 . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements."

Id. at 241–42 (quoting Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986)); *see also* Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435 (1984) (tracing the development of the fraud on the market theory as well as examining objections to the theory); Barbara Black, *The Strange Case of Fraud on the Market: A Label in Search of a Theory*, 52 ALB. L. REV. 923, 926 (1988) (arguing that the Supreme Court in *Basic* left open the possibility that a pure causation approach is an appropriate explanation of fraud on the market); Michael A. Lynn, Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 GEO. WASH. L. REV. 627 (1982) (exploring the development of the fraud on the market theory of civil liability under rule 10b-5); Mark H. Van De Voorde, Note, *The Fraud on the Market Theory and the Efficient Markets Hypothesis: Applying a Consistent Standard*, 14 J. CORP. L. 443 (1989) (explaining the fraud on the market theory).

[138] *Emergent Capital*, 343 F.3d at 197; *see also Lentell*, 396 F.3d at 174 ("[O]ur precedents make clear that loss causation has to do with the relationship between the plaintiff's investment loss and the information misstated or concealed by the defendant." (citing *Emergent Capital*, 343 F.3d at 198–99; Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 186–90 (2d Cir. 2001); Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 96–98 (2d Cir. 2001))).

[139] *Castellano*, 257 F.3d at 186 (quoting First Nationwide Bank v. Gelt Funding Corp, 27 F.3d 763, 769 (2d Cir. 1994)).

[140] *See Lentell*, 396 F.3d at 172 ("Plaintiffs do not claim to have read Merrill's reports, or to have bought 24/7 Media or Interliant securities through the Firm; instead, they rely on the fraud-on-the-market presumption blessed in *Basic v. Levinson*. We assume for present purposes that the allegations could amount to a fraud on the market.") (citation omitted).

causation standard.[141]

Further confounding the inherent complexity in these causation requirements, the hallowed halls of 40 Foley Square,[142] by way of a trilogy of recent decisions,[143] imposed the additional tort law concept of foreseeability[144] and the Seventh Circuit's "materialization of the risk"[145] constraint into its loss causation equation. To establish foreseeability the court examines whether it was reasonably foreseeable that the alleged misrepresentation or omission would lead to the market devaluation causing a plaintiff's loss.[146] On the other hand, to establish "materialization of the risk," a plaintiff must show that the "loss was caused by the materialization of a risk that was undisclosed because of the defendant's fraud."[147] One facet of *Lentell*'s importance is that the circuit made abundantly clear that both of these prerequisites—foreseeability and the materialization of risk—remain viable in the Second Circuit's approach to loss causation.[148] As a result, it is suggested that the circuit's

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[141] *See id.* at 177 (concluding that the dismissal of the complaint was proper under a failure to adequately plead loss causation, as the plaintiffs "offer no factual basis to support the allegation that Merrill's misrepresentations and omissions caused the losses flowing from the well-disclosed volatility of securities issued by 24/7 Media and Interliant").

[142] The current building address for the United States Court of Appeals for the Second Circuit is 40 Foley Square, although the court is actually located at 40 Centre Street. See U.S. COURT OF APPEALS, SECOND CIRCUIT, *Travel Directions*, at http://www.ca2.uscourts.gov/ CourtMap.htm#directions (last visited Apr. 10, 2005). Foley Square, as well as the other surrounding courthouses and government buildings, were built over the infamous Five Points section of lower Manhattan. See NYC-Architecture.com, *The U.S. Courthouse*, at http://www.nyc-architecture.com/ SCC/SCC021.htm (last visited Apr. 10, 2005).

[143] *See Emergent Capital*, 343 F.3d at 196–98; *Castellano*, 257 F.3d at 190; *Suez Equity Investors*, 250 F.3d at 96–98 (holding that loss causation was met because "the defendants' misrepresentations induced a disparity between the transaction price and the true 'investment quality' of the securities at the time of transaction").

[144] *See, e.g.*, *Castellano*, 257 F.3d at 186; *First Nationwide Bank*, 27 F.3d at 769; Citibank, N.A. v. K-H Corp., 968 F.2d 1489, 1495 (2d Cir. 1992).

[145] *See, e.g.*, Bastian v. Petren Res. Corp., 892 F.2d 680, 684–86 (7th Cir. 1990); Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 716–23 (2d Cir. 1980) (Meskill, J., dissenting).

[146] *See Castellano*, 257 F.3d at 190 ("[F]oreseeablity links the omitted information and the ultimate injury in this case . . . ."); *First Nationwide Bank*, 27 F.3d at 769; *Citibank*, 968 F.2d at 1495 (holding that a plaintiff must show that the loss was the "foreseeable consequence" of the defendant's misrepresentations or omissions).

[147] Escoffery, *supra* note 20, at 1803, 1804 n.207 (citing Judge Posner's opinion in *Bastian* as the origin of the materialization of the risk approach).

[148] *See* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005). In

reaffirmation of its post-*Suez* precedents in *Lentell* quelled much of the debate surrounding the import of these somewhat amorphous loss causation factors. This, in turn, offered little solace to plaintiffs' class action lawyers struggling with these concepts, yet provided significant fodder for the cannons of the securities defense bar.[149]

It goes without saying that courts must look to Congress's statutory intentions when construing the securities laws, or any other law for that matter.[150] Congress, however, looked instead to the courts, particularly to the Second Circuit, for guidance in drafting the PSLRA.[151] As a result, Congress codified much of

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affirming the circuit's prior decision in *Suez Equity Investors*, although arguably limiting the breadth of its application, the *Lentell* court stated:

> We acknowledge that the pleading principles set out in the foregoing passage require both that the loss be foreseeable *and* that the loss be caused by the materialization of the concealed risk; and we further acknowledge that our opinion in *Suez Equity* can be (mis-)read to say that this Circuit has rejected the "materialization of risk" approach. . . .
>
> This Court's cases—post-*Suez* and pre-*Suez*—require both that the loss be foreseeable *and* that the loss be caused by the materialization of the concealed risk.

Id. at 173 (citing *Emergent Capital*, 343 F.3d at 197–98; *Castellano*, 257 F.3d at 188, 190; *Suez Equity Investors*, 250 F.3d at 97, 98 n.1; *First Nationwide Bank*, 27 F.3d at 769; *Citibank*, 968 F.2d at 1495); *see also* AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 235 (2d Cir. 2000) (Winter, J., dissenting).

[149] Hamblett, *supra* note 19 (commenting that *Lentell* "raises the bar high for suits based on analyst recommendations and jeopardizes dozens of such actions against Merrill Lynch").

[150] *See* Sachs, *supra* note 130, at 96, 98 & n.13 (stating that "the Court has indicated that the intent of Congress governs the elements of the rule 10b-5 action," and citing as examples: Dirks v. SEC, 463 U.S. 646, 655 (1983); Chiarella v. United States, 445 U.S. 222, 233 (1980); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472, 479 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975)).

[151] Congress substantially adopted the Second Circuit's pleading standards in the PSLRA. *See* Novak v. Kasaks, 216 F.3d 300, 310 (2d Cir. 2000):

> We conclude that the PSLRA effectively raised the nationwide pleading standard to that previously existing in this circuit and no higher . . . .
>
> . . . .
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> . . . As far as the general purposes of the PSLRA are concerned, Congress plainly sought to impose a stricter nationwide pleading standard and did so. But this purpose does not require raising the standard above that of this circuit, particularly in light of the explicit Congressional recognition that our pre-PSLRA standard was the most stringent in the nation.

Id; *see also* S. REP. NO. 104-98, at 7 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 686 (discussing the legislative purpose in drafting the loss causation provision into the PSLRA as, "codifying the requirement under current law that plaintiffs prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors").

the Second Circuit's loss causation prerequisites under section 21D of the PSLRA,[152] which states that "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter *caused the loss* for which the plaintiff seeks to recover damages."[153] This statutory provision codifies what the Second, Third, Fourth, Seventh, and Eleventh Circuits require: that plaintiffs plead and prove that the defendants' misstatements or omission formed the causal basis for the stock's decline in market value.[154] Conversely, both the Eight and Ninth Circuits took a strikingly different and far more lenient approach to loss causation.[155] Both of these circuits merely required some showing of artificial price inflation, which focuses not on the causal link between the fraud and the stock's

[152] 15 U.S.C. § 78u–4(b)(4) (2000).

[153] *Id.* (emphasis added).

[154] Eisenhofer et al., supra note 129, at 1430–37 (outlining thoroughly the similar loss causation pleading standard—that the alleged fraud caused the decline in stock price—utilized by the Second, Third, Fourth, Seventh, and Eleventh Circuits, as compared to the divergent loss causation standard—that there was an artificial price inflation at the time of purchase—employed by the Eight and Ninth Circuits).

[155] *Compare* Broudo v. Dura Pharms., Inc., 339 F.3d 933, 938–39 (9th Cir. 2003), *rev'd*, Dura Pharms., Inc. v. Broudo, No. 03-932, 2005 WL 885109 (U.S. April 19, 2005), at *1, 125 S. Ct. 1627 (2005) ("Our cases have held . . . that: '[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price . . . was inflated because of the misrepresentation.'") (citations omitted), *and* Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 831–32 (8th Cir. 2003) (holding that loss causation could be established under an artificial inflation of price theory), *with* Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 198–99 (2d Cir. 2003) (holding that price inflation, without more, was not sufficient under the Second Circuit's approach to loss causation), *and* Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) (agreeing with the rationale of an Eleventh Circuit decision which held that price inflation alone is not sufficient to satisfy the loss causation requirement), *and* Robbins v. Koger Props. Inc, 116 F.3d. 1441, 1447–48 (11th Cir. 1997) ("Our cases do not hold that proof that a plaintiff purchased securities at an artificially inflated price, without more, satisfies the loss causation requirement."), *and* Bastian v. Petren Res. Corp., 892 F.2d 680, 684–86 (7th Cir. 1990) (squarely disagreeing with the artificial price inflation theory of loss causation).

This circuit split lead the Supreme Court to grant certiorari in *Dura Pharmaceuticals*, where the Court inevitably held that the Eighth and Ninth Circuit's artificial price inflation theory "was inconsistent with the law's requirement that a plaintiff prove that defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss," in turn affirming the Second, Third, Seventh, and Eleventh Circuit's requirement for a causal link between the fraud and the drop in price. *See* Dura Pharms., Inc. v. Broudo, No. 03-932, 2005 WL 885109 (U.S. April 19, 2005), at *1, *6, 125 S. Ct. 1627 (2005); *see also supra* note 21.

decline in price, but rather on whether the stock's price was inflated at the time of purchase based on the alleged misrepresentation or omission.[156] Unfortunately, a critique of these two divergent loss causation standards is beyond the scope of this Comment. It is suggested, however, that the Second Circuit's narrow loss causation approach—as clarified in *Lentell* and unanimously affirmed in *Dura Pharmaceuticals*—is far more in keeping with Congress's obvious intentions in drafting the PSLRA.

Based on the foregoing, the plaintiffs in *Lentell* had to establish that Merrill Lynch's failure to disclose its analysts' conflicts of interest satisfied the requirements of both transaction causation and loss causation.[157] As to the transaction causation prong, the *Lentell* plaintiffs, without contest from the defendants, relied on the fraud on the market theory to establish transaction causation.[158] The circuit and the district courts held steadfast to the supposition that "the fraud on the market theory, as articulated by the Supreme Court, is used to support a rebuttable presumption of reliance, not a presumption of causation."[159] The fraud on the market theory cannot be used to shoe horn a showing of transaction causation into a showing of the more complicated and difficult loss causation standard.[160]

In wrestling with the loss causation requirement, the plaintiffs made a brash and largely misdirected attempt at striding over the loss causation hurdle by arguing that "the 'Internet bubble' was a classic stock market manipulation engineered by Wall Street's investment bankers and research

[156] "[L]oss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause." *Dura Pharms.*, 339 F.3d at 938, *rev'd*, No. 03-932, 2005 WL 885109 (U.S. April 19, 2005), at *1, 125 S. Ct. 1627 (2005).

[157] *See* Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005).

[158] *See id.* ("Plaintiffs do not claim to have read Merrill's reports, or to have bought 24/7 Media or Interliant securities through the Firm; instead, they rely on the fraud-on-the-market presumption blessed in *Basic v. Levinson*.") (citation omitted).

[159] *See Robbins*, 116 F.3d. at 1448 (citing Basic Inc. v. Levinson, 485 U.S. 224, 241–42); *see also Emergent Capital*, 343 F.3d at 198 (expounding on its decision in *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 96–99 (2d Cir. 2001), and clarifying that transaction causation and loss causation are two distinct elements that must be independently pleaded and proven).

[160] *See Emergent Capital*, 343 F.3d at 198; *Suez Equity*, 250 F.3d at 96–99; *Robbins*, 116 F.3d at 1448.

analysts."[161] The weight of the plaintiffs' argument collapsed on itself. The district court hastily discounted this reckless allegation: "There is no factual predicate or legitimate inference from the facts alleged . . . for plaintiffs' semantic invention of a stock market manipulation for internet company securities . . . ."[162] Giving short shrift to the plaintiffs' arguments, the district court opined that it was the sudden deflation of the technology stock bubble that caused the market depreciation of the stocks at issue, not the failure to disclose alleged conflicts of interest.[163] Moreover, both courts swiftly distinguished the present case from others in which the Second Circuit found that loss causation was established based on a combination of theories such as the materiality of the concealed risk and artificial price inflation.[164] The circuit noted that the plaintiffs did not allege that the "'*subject* of the fraudulent statement'" was Merrill Lynch's recommendation to buy shares in these Internet companies, nor that Merrill Lynch made a subsequent "corrective disclosure" in reference to its recommendations, nor that Merrill Lynch concealed the risks associated with either of the

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[161] *In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 362 (S.D.N.Y. 2003).

[162] *Id.* ("Not even the freewheeling investigation and report make any such assertion or suggestion as a prop for its criticisms."). The Second Circuit cited the opinion of one member of its panel, Barrington D. Parker, who served years earlier as a district court judge. *See Lentell*, 396 F.3d at 177 ("[P]laintiffs have not made out a market manipulation claim under Rule 10b-5(a) and (c), and remain subject to the heightened pleading requirements of the PSLRA." (citing Schnell v. Conseco, Inc., 43 F. Supp. 2d 438, 447–48 (S.D.N.Y 1999))).

[163] *Merrill Lynch*, 273 F. Supp. 2d at 362 ("The alleged omissions are not the 'legal cause' of the plaintiff's [sic] losses. There was no causal connection between the burst of the bubble and the alleged omissions; it was the burst which caused the market drop and the resultant losses a considerable time thereafter when plaintiffs decided it was time to sell.").

[164] *See Lentell*, 396 F.3d at 177 (explaining that *Lentell* "is therefore sharply distinguishable from cases in which some or all of the risk that materialized was clearly concealed by a defendant's misstatements or omissions" such as *Emergent Capital*, 343 F.3d at 196–99 and *Suez Equity*, 250 F.3d at 97–98). In the lower court, the plaintiffs relied on Judge Cote's *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392 (S.D.N.Y. 2003) decision in an attempt to base loss causation on an artificial price inflation theory. Yet, Judge Pollack aptly retorted that, unlike the situation in *WorldCom*, "[t]he complaints at issue here allege neither that Merrill Lynch possessed material nonpublic information regarding the financial condition of 24/7 or Interliant, nor the existence of any such undisclosed financial arrangements." *Merrill Lynch*, 273 F. Supp. 2d at 364 n.25 ("The Court respectfully submits that the *WorldCom* decision is not broad enough to cover the allegations here.") (footnote omitted).

companies in question.[165] Yet, the *Lentell* plaintiffs misguidedly argued that the "defendant's misrepresentations and omissions induced a 'purchase-time value disparity' between the price paid for a security and its 'true investment quality.'"[166] Squarely disagreeing with the plaintiffs' suggestion, the circuit enlisted the service of a prior decision where it sounded the death knell to this line of debatable reasoning.[167]

In dicta, the court candidly remarked that members of the Second Circuit have historically "disagreed as to whether certain losses were attributable to a concealed risk."[168] As a result of this disparity, the circuit explained the proper application of its loss causation calculus, drawing considerably from three key decisions:

> [O]ur precedents make clear that loss causation has to do with the relationship between the plaintiff's investment loss and the information misstated or concealed by the defendant. If that relationship is sufficiently direct, loss causation is established, but if the connection is attenuated, or if the plaintiff fails to "demonstrate a causal connection between the content of the alleged misstatements or omissions and 'the harm actually suffered,'" a fraud claim will not lie.[169]

The precedential jewel in *Lentell* came when the circuit, citing no authority for its pronouncement, uncluttered much of the ambiguity enveloping loss causation by reducing its loss

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[165] *See Lentell*, 396 F.3d at 175 (citation omitted) (concluding that plaintiffs failed to allege loss causation because "[t]here is no allegation that the market reacted negatively to a corrective disclosure regarding the falsity of Merrill's 'buy' and 'accumulate' recommendations and no allegation that Merrill misstated or omitted risks that did lead to the loss").

[166] *Id.* at 174 (quoting *Emergent Capital*, 343 F.3d at 198).

[167] *See id.* at 174–75. Rejecting the plaintiffs' argument, the *Lentell* court concluded:

> '[W]hen the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases,' and a plaintiff's claim fails when 'it has not adequately ple[]d facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events.'

Id. at 174 (alteration in original) (quoting First Nationwide Bank v. Gelt Funding Corp, 27 F.3d 763, 772 (2d Cir. 1994)).

[168] *Id.* (citing Judge Jacobs's own concurrence in the mandate in *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 224–28 (2d Cir. 2000)).

[169] *Id.* (citing and quoting *Emergent Capital*, 343 F.3d at 198–99; Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 186–90 (2d Cir. 2001); *Suez Equity*, 250 F.3d at 96–98).

causation standard into a neatly packaged gift for practitioners and law students alike: "To plead loss causation, the complaints must allege facts that support an inference that Merrill's misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud."[170]

The circuit dealt its *coup de grace* by emphasizing that the plaintiffs "fail[ed] to grapple" with "the price-volatility risk inherent in the stocks they chose to buy."[171] All of the analysts' reports were clearly captioned with warnings of the high level of investment risk involved in these stocks.[172] It was this "systematic and consistent risk indicator" denoted on the reports in question that sealed the loss causation fate of the plaintiff class.[173] With constructive knowledge of the inherent risks at play in these investments from the outset, how could the plaintiffs plead that their losses were causally linked to a later materialization of the risks that were known at the time of purchase?[174] Such reasoning defies logic.

When viewed in the aggregate, by clarifying its prior decisions in *Emergent Capital*, *Castellano*, and *Suez Equity*, it is submitted that the Second Circuit reinvigorated its loss causation standards, stripping away much of the confusion and ambiguity that had crept into the application of its loss causation principles by the various courts within the Second Circuit.[175]

[170] *Id.* at 175.

[171] *Id.* at 176.

[172] *See id.* at 176–77.

[173] *Id.* ("Plaintiffs do not allege that Merrill 'doctored' or hid, or omitted this information, all of which suggests that 24/7 Media and Interliant were volatile, devaluation-prone investments and that Merrill revealed as much in its reports.").

[174] *Id.* ("To plead successfully that Merrill's fraud caused their losses, plaintiffs were required to allege facts to establish that the Firm's misstatements and omissions concealed the price-volatility risk (or some other risk) that materialized and played some part in diminishing the market value of 24/7 Media and Interliant.").

[175] *Compare* DeMarco v. Robertson Stephens Inc., No. 03 Civ. 590(GEL), 2005 WL 120233, at *7 (S.D.N.Y. Jan. 20, 2005) (holding that the fraud-on-the-market presumption satisfied the loss causation pleading standard), *and In re* WorldCom, Inc. Sec. Litig., 219 F.R.D. 267, 300 (S.D.N.Y. 2003) (holding the fraud-on-the-market presumption satisfied the loss causation pleading), *with* DeMarco v. Lehman Bros. Inc., 222 F.R.D. 243, 245 (S.D.N.Y. 2004) (holding that the fraud-on-the-market presumption would not satisfy the loss causation pleading as the plaintiffs must still establish the causal connection between the fraud and the drop in stock price).

This Comment submits that the *Lentell* decision—irrespective of its dispositive affect on analyst conflict cases—will be noted, and perhaps criticized, for parsing through the fuzzy lines drawn by prior precedents, culling from a chosen few decisions the pearls that represent the central focus of the Second Circuit's loss causation standard, while leaving behind most of the defective reasoning and ambiguity.

CONCLUSION: THE REACH OF *LENTELL*

Lentell unequivocally makes the already uphill battle even steeper for putative plaintiff classes alleging a violation of the federal securities laws based on analyst conflicts of interest. By providing black-letter guidance on what must be pleaded and proven to establish loss causation, the *Lentell* court made the historically elusive requirement of loss causation—especially as applied to analysts' conflicts of interest—far less evasive. Now that the loss causation standard has been clarified, it is submitted that many more dismissals will be granted in securities analyst conflict cases for failure to adequately plead loss causation. This was a substantial gift to Wall Street, as it provided a reprieve from the bombardment of class action lawsuits it is presently embroiled in defending.

Nonetheless, the *Lentell* court passed on a small parting gift to similarly situated plaintiffs; it tempered the draconian application of Congress's brisk statute of limitations. By insisting that district courts conduct a careful, fact-specific examination of the available information to see if inquiry notice was implicated, the circuit reconfirmed that only particularized, issuer-specific data that places a reasonable investor on notice of potential securities fraud would trigger the commencement of the statute of limitations clock.

It is suggested that the precedential significance of the *Lentell* decision reaches far beyond the analysts' conflicts of interest cases. The Second Circuit established that it is unwavering in its role as a PSLRA gatekeeper, ensuring that pleading standards remain at the level originally intended by Congress. Moreover, by clarifying prior and somewhat contradictory Second Circuit decisions dealing with loss causation, the *Lentell* panel answered a few of the questions that troubled both sides of the counsel table, as well as the bench, in securities fraud cases dealing with the PSLRA requirements.

Moments of judicial clarity, like those found in *Lentell*'s thorough analysis, serve as an exemplar—be it mandatory or persuasive—for district courts both within and without the Second Circuit as federal courts continue to grapple with the proper application of the loss causation requirement.