FIFO vs LIFO

Different ways to calculate shareholder losses for purposes of appointing lead plaintiff lead to different results

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In law, as in life, different paths often lead to different results. In the context of securities class action litigation and the calculation of shareholders' losses, this often becomes evident during the battle for lead plaintiff. Alternative methods of calculating a shareholder's losses can result in very different amounts of those 'losses'. In fact, where one methodology appears to show substantial investor losses, courts have sometimes found that another, more appropriate, methodology shows substantial investor losses, courts have sometimes found that another, more appropriate, methodology shows substantial investor profits under the same facts.

Since the Private Securities Litigation Reform Act of 1995 (PSLRA) does not require that one particular method be used for calculating losses, it is imperative that when engaged in a contest for lead plaintiff, a shareholder carefully considers competing loss calculation methodologies. This is crucial since the method selected by a competing lead plaintiff (or by the court) will, in many cases, be determinative as to who will be appointed lead plaintiff. Knowledgeable counsel can often persuade the court to use the appropriate methodology.

The PSLRA presumes that the most adequate shareholder to protect the interests of the class (the 'lead plaintiff') is the investor that has the largest financial interest in the litigation and has made a timely motion to serve as the lead plaintiff. In other words, the primary factor for selection of lead plaintiff is how much money the shareholder lost on his investment in the stock during the time of the alleged fraud.

However, while the PSLRA requires that a shareholder seeking to be lead plaintiff file a certification containing, among other things, a list of his transactions in the stock, it provides no specific method for calculating his financial loss. As of this time, two competing methodologies have emerged as the principle loss calculation methodologies:

- the 'first-in/first-out' (FIFO) method, and
- The 'last-in/first-out' (LIFO) method.

Until recently, the FIFO methodology was the more common approach to calculating shareholder losses. Under this method, to calculate class period losses, the first shares sold by a prospective lead plaintiff during the class period are matched against the first shares purchased by that shareholder. Thus, if a shareholder had purchased shares of the security prior to the class period, those pre-class purchases (ie, the shareholder's holdings at the start of the class period) are matched against the first shares sold during the class period, and any resulting gain or loss would be excluded from that shareholder's loss calculation. Once all pre-class period purchases have been offset, class period sales will then be matched against class period purchases to determine the shareholder's losses. Further, shares retained by the shareholder after the class period ends are typically assigned a value equal to the 90 day post-fraud average price.

For example, assume that Pension Fund A holds 10,000 shares of Company XYZ at the beginning of the class period. During the class period, Pension Fund A buys and sells as follows:

- Sale – 10,000 shares, at $110/share, with total proceeds of $1,100,000
- Purchase – 10,000 shares, at $100/share, for a total cost of $1,000,000

In calculating losses under a FIFO-based methodology, Pension Fund A's sale of 10,000 shares of XYZ stock during the class period will be offset or matched against its pre-class period holdings, and, in effect, these sales will be 'zeroed out'. Next, assuming that the post-class period 90-day average price of a share of XYZ stock is $80, Pension Fund A's loss would be $200,000, calculated as follows:

- Purchase price ($100) – 90-day average price ($80) x 10,000 shares = $200,000 Loss[1]

Although the FIFO methodology has been accepted by many courts, recently there has been a strong trend towards using the LIFO methodology. Proponents of LIFO argue that FIFO often provides an inaccurate result by 'zeroing out' intra-class period sales with shares that were purchased prior to the class period – ie, at a time when the stock price had no artificial inflation due to the alleged fraud. Put differently, when pre-class period pur-

[1] It is important to note that the 'losses' for purposes of determining the lead plaintiff in a PSLRA action is *not* the same as 'damages', which is the amount of money that class members would be entitled to receive if the plaintiffs win the case at trial. Damages can be described as those losses that were actually caused by the fraud. Assume, for example, that an investor purchased a stock at $100 per share during the class period, the stock then declined by $20 per share for reasons unrelated to the fraud, and then declined by another $10 per share when the fraud was revealed, so that its price was $70 at the end of the class period. Under these facts, the investor has PSLRA losses of $30 per share, but damages of only $10 per share.

chases were made, there was no artificial inflation in the stock price. If those shares were later sold during the class period while the stock was inflated, the shareholder actually benefited from the fraud by selling at a higher price than the fair value of the stock. FIFO disregards those profits and thereby exaggerates shareholders' fraud-related losses.

In contrast, under a LIFO inquiry, a shareholder first matches his sales of a security during the class period against the last shares purchased during the class period (rather than against shares he held at the start of the class period). If the price of a stock was inflated by $10 per share when the shareholder purchased it, and was still inflated by $10 per share when the shareholder sold it, this method eliminates the losses on the purchase by matching them with corresponding gains on the sales. Indeed, in *Dura Pharmaceuticals, Inc. v. Broudo*,[2] the United States Supreme Court recently noted that "if … the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss".

The following analysis illustrates how LIFO can provide a very different result from FIFO. Pursuant to LIFO, class-period sales would not be offset against pre-class period holdings. Rather, Pension Fund A would match the last purchase it made during the class period with the first sale it made during the class period. Using the same assumptions set forth in the hypothetical above, the calculation is as follows:

- Sale proceeds ($1,100,000) – Cost of shares ($1,000,000) = $100,000 Gain

Thus, rather than having a $200,000 loss under FIFO, Pension Fund A would have a $100,000 gain under LIFO. This seems to be a fair result because with respect to the 10,000 shares of XYZ stock that Pension Fund A purchased and sold during the class period – ie, during the time when the price of XYZ stock may have been inflated due to the alleged fraud – Pension Fund A apparently did not suffer any financial loss (assuming that the stock price was inflated by the same amount throughout the class period).

This hypothetical has many real life counterparts. In *In re Cardinal Health, Inc. Securities Litigation*, for example, the court rejected the use of the FIFO method and noted that one pension fund that "reported a loss of approximately $1.9 million … actually had a net gain of approximately $7 million when sales of pre-class period holdings are counted. Similarly, [another pension fund] reported a loss of approximately $2.1 million, but actually had a net gain of approximately $4.7 million when sales of pre-class period holdings are incorporated."[3]

Similarly, in *In re eSpeed, Inc. Securities Litigation*,[4] the court recently rejected the supposedly larger loss of a movant who used the FIFO method in favour of another applicant who used the LIFO method. Judge Shira Scheindlin explained that "the main advantage of LIFO is that, unlike FIFO, it takes into account gains that might have accrued to plaintiffs during the class period due to the inflation of the stock price. FIFO, as applied by the pension fund and others, ignores sales occurring during the class period and hence may exaggerate losses."

Likewise, just last month in *Johnson v. Dana Corporation*, Chief Judge James Carr of the Northern District of Ohio stated, in finding that LIFO rather than FIFO must be used for determining losses in a lead plaintiff motion, that "using FIFO, plaintiffs with significant preexisting holdings of defendants' securities can profit substantially from defendant's misconduct and then turn around and show a loss for purposes of litigation". Thus, the current trend seems to be firmly in favour of LIFO over FIFO.

A related issue in lead plaintiff motions is whether a shareholder who sold more shares during the class period than he bought (a 'net-seller') can be appointed as a lead plaintiff. Some courts, assuming that the price of the stock was inflated by the same amount throughout the class period, have held that net-sellers cannot be adequate lead plaintiffs because they profited by the artificial inflation.[5] This theory seems to work best in cases where there is a single disclosure of the wrongdoing at the end of the class period. In such a case if a shareholder sold 10,000 shares of stock during the class period and purchased only 8,000 shares, and the stock was inflated by $10 per share at all times, then the shareholder would have profited from other fraud by $20,000.

- 10,000 shares sold – 8,000 share bought = 2,000 net shares sold x $10 per share = $20,000

However, in cases where plaintiffs allege that the truth about the fraud was disclosed to investors through a number of partial disclosures, the artificial inflation in the stock was lower at some times during the class period (ie, after the first partial disclosure) than at other times. Courts have held that under those circumstances, a net seller can be the lead plaintiff.[6]

As these scenarios demonstrate, the determination of losses in an application for lead plaintiff can be complex, with many traps for the unwary. It is crucial that a shareholder seeking appointment as lead plaintiff carefully consider the methodology used in calculating its financial loss, as well as the methodologies used by other prospective lead plaintiffs, since methodology alone may dictate who will be appointed lead plaintiff. ■

2 125 S. Ct. 1627 (2005).

3 226 F.R.D. 298 (S.D. Ohio 2005).

4 232 F.R.D. 95 (S.D.N.Y. 2005)

5 In re Comdisco Sec. Litig., 150 F.Supp. 2d 943, 945 (N.D.Ill. 2001).

6 In re NTL, Inc. Securities Litigation, 2006 WL 330113, *10(S.D.N.Y. Feb. 14, 2006) ("Plaintiffs … allege several disclosing events throughout the class period that gradually alerted investors to the truth about NTL.")