

Client Alert

A report
for clients
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of the firm May 2005

Supreme Court Clarifies Loss Causation Standard

Introduction

On April 19, 2005, the Supreme Court of the United States resolved a split among the circuit courts concerning the standard for alleging loss causation under Section 10(b) of the Securities Exchange Act of 1934. In *Dura Pharmaceuticals, Inc. v. Broudo*¹, the Supreme Court reversed a Ninth Circuit decision that held it was only necessary to plead “1) that the stock’s price at the time of purchase was overstated and 2) sufficient identification of the cause for this overvaluation.” *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, 939 (9th Cir. 2003). The Ninth Circuit reasoned that the plaintiff suffered the requisite loss at the time the plaintiff purchases the security at an allegedly inflated price. *Id.* at 938. The Supreme Court reversed, stating that at the moment of the purchase “the plaintiff has suffered no loss” and held that a securities fraud plaintiff must allege a causal connection between a subsequent drop in the price of the stock and the allegedly false statement. *Dura Pharmaceuticals*, slip op. at 5, 9.

Facts

In *Dura Pharmaceuticals*, plaintiff, on behalf of a putative class, sued Dura Pharmaceuticals (“Dura”) and certain officers and directors alleging that during the purchase period, April 15, 1997 to February 24, 1998, Dura made false statements which inflated the price of Dura stock. Allegedly, Dura falsely claimed that its drug sales would be profitable and that the FDA would soon grant approval to a new asthmatic spray device that Dura was developing.

Plaintiffs claimed that: (1) on February 24, 1998, the last day of the purchase period, Dura announced that due mainly to slow drug sales, Dura’s earnings would be lower than previously expected; (2) the next day, the price of Dura’s stock dropped almost 50%, from

approximately \$39 per share to approximately \$21 per share; (3) the stock price continued to drop and, on November 3, 1998, approximately eight months after the February 1998 price drop, Dura announced that the FDA would not approve the asthmatic spray device; (4) the next day Dura’s share price temporarily fell from a November 3 closing price of \$12.375 to a November 4 closing price of \$9.75; (5) over the next twelve trading days, the price recovered to \$12.438. See *Dura Pharmaceuticals*, slip op. at 2; Brief for Petitioners at 6, *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. ____ (2005) (No. 03-932). The plaintiffs also alleged that, during the relevant purchase period, “[i]n reliance on the integrity of the market, [the plaintiffs]...paid artificially inflated prices for Dura securities’ and the plaintiffs suffered ‘damage[s]’ thereby.” *Dura Pharmaceuticals*, slip op. at 2. The plaintiffs did not allege that damages were caused by the alleged misstatements or omissions. *Id.* at 10.

The District Court dismissed the complaint, finding that with respect to the drug profitability claim, that the complaint “failed adequately to allege an appropriate state of mind, i.e., that defendants had acted knowingly, or the like.” *Id.* at 2-3. The District Court also dismissed the complaint with respect to the asthmatic spray device, holding that “the complaint failed adequately to allege ‘loss causation.’” *Id.* at 3. The Ninth Circuit reversed and held the complaint adequately alleged loss causation as to the asthmatic spray device. In the Ninth Circuit, “loss causation [was] satisfied where the plaintiff shows that the misrepresentation touches upon the reasons for the investment’s decline in value.” *Broudo*, 339 F.3d at 938 (internal quotation marks omitted). “[P]laintiffs establish loss causation if they have shown that the price *on the date of purchase* was inflated because of the misrepresentation.” *Id.* (emphasis in original; internal quotation marks omitted).

The Supreme Court’s decision in *Dura Pharmaceuticals* was limited to the loss causation issue concerning the asthmatic spray device. The

¹ No. 03-932, 544 U.S. ____ (2005).

plaintiffs' allegations concerning Dura's alleged misstatements about profitability were not at issue.

Loss Causation

Loss causation, or "a causal connection between the material misrepresentation and the loss," is one of the elements a securities fraud plaintiff must allege and prove. *Dura Pharmaceuticals*, slip op. at 4. In an action "involving publicly traded securities and purchases or sales in public securities markets" a plaintiff must allege and prove six basic elements: (1) a material misrepresentation or omission; (2) scienter (a wrongful state of mind); (3) a connection with the purchase or sale of a security; (4) reliance upon the misstatement or omission (this is also referred to as transaction causation); (5) economic loss; and (6) loss causation. *Id.* at 4.

The Ninth Circuit had adopted a relatively relaxed standard of loss causation. Under its holding in *Broudo*, a plaintiff adequately pleads loss causation by averring that the misstatements inflated the price of the security at the time of purchase. *Broudo*, however, was in conflict with holdings of the Second, Third, Seventh and Eleventh Circuits, which had held that the plaintiff must plead that the allegedly false statements were responsible for a decline in the stock price. *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197-98 (2d Cir. 2003); *see also Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000) ("[b]ecause a plaintiff in an action under § 10(b) and Rule 10b-5 must prove that he or she suffered an actual economic loss, we are persuaded that an investor must also establish that the alleged misrepresentations proximately caused the decline in the security's value to satisfy the element of loss causation"), *cert. denied*, 531 U.S. 1149 (2001); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997) ("[t]o prove loss causation, a plaintiff must show that the untruth was in some reasonably direct, or proximate, way responsible for his loss") (internal quotations marks omitted); *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990) (Posner, J.) ("'[L]oss causation' is an exotic name — perhaps an unhappy one...for the standard rule of tort law that the plaintiff must allege and prove that, but for the defendant's wrongdoing, the plaintiff would not have incurred the harm of which he complains"). In contrast, only the Eighth Circuit has agreed with the Ninth Circuit's reasoning. *See Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 832 (8th Cir. 2003) ("[t]he fraud-on-the-market theory...allow[s] the fact finder to presume that the stock's price reflected the inflated earnings, and it makes sense to conclude that the plaintiffs were harmed when they paid more for the stock than it was worth. This is a sufficient allegation").

Both the Second and Eleventh Circuits have rejected the reasoning behind the Ninth Circuit opinion in *Broudo*. *Emergent Capital*, 343 F.3d at 198 ("[p]laintiff's allegation of a purchase-time value disparity, standing alone, cannot

satisfy the loss causation pleading requirement") (decision issued approximately one month after the *Broudo* decision); *Robbins*, 116 F.3d at 1448 ("[o]ur cases do not hold that proof that a plaintiff purchased securities at an artificially inflated price, without more, satisfies the loss causation requirement").

The Supreme Court's Decision

The Supreme Court rejected the Ninth Circuit's approach and held that a plaintiff in a securities fraud action must "prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss." *Dura Pharmaceuticals*, slip op. at 9.

The Court disagreed with the Ninth Circuit for three reasons. First, at the moment the plaintiff purchases a stock at an allegedly inflated price, no loss has occurred; there must be a price decline for a loss to occur. "Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong." *Id.* at 5. There is no guarantee of later loss, or even that such a loss would be caused by the misrepresentation. It is entirely possible that the loss could be caused by other factors or events, such as an economic downturn or changed investor expectations. *Id.* at 5-6. With regard to the Ninth Circuit's "touch upon" standard, the Court stated that an inflated price may "'touch[] upon' a later economic loss...[b]ut even if that is so, it is insufficient. To 'touch upon' a loss is not to cause a loss, and it is the latter that the law requires." *Id.* at 6 (emphasis in original).

Second, the Ninth Circuit's opinion in was contrary to common law precedent which requires a plaintiff to "show not only that had he known the truth he would not have acted but also that he suffered actual economic loss." *Id.* at 6.

Third, the Ninth Circuit ruling did not advance an important objective of the securities laws to "maintain public confidence in the marketplace." *Id.* at 8. Securities laws and regulations maintain public confidence by deterring fraud and providing protection "against those economic losses that misrepresentations actually cause." *Id.* at 8. Securities laws do not exist to provide insurance against all losses. By adopting an "inflated price" standard of loss causation, rather than one that requires the misrepresentation to have been responsible for actual economic loss, the Ninth Circuit's holding was more akin to insurance than to a remedy for losses caused proximately by fraud.

Significance

Dura Pharmaceuticals is a significant decision. No longer will plaintiffs in the Eighth and Ninth Circuits be able to allege merely that the stock price was inflated on the date of purchase by the alleged misstatements. So, too, will any doubt be dispelled that the Second, Third, Seventh, and

Eleventh Circuits had articulated the correct loss causation formulation.

Of perhaps greater significance is the question whether the Supreme Court's reasoning will afford defendants broader grounds (even in circuits that had followed the stricter pleading standard) on which to challenge the pleading of loss causation, or to make summary judgment motions once the record is more developed. The Court's recognition that the "link between the inflated share purchase price and any later economic loss is not invariably strong," *Id.*, at 5, and that a drop in price may reflect, "not the earlier misrepresentation," but a host of other factors, suggests that plaintiffs may face a heightened burden. *Id.* This is particularly true where a substantial time elapses between the alleged misrepresentation and the price drop. If there are intervening price declines or volatility, the market moves down sharply as a whole, or the company or its market segment is affected materially by events unrelated to the misrepresentation, then the necessary causal link may become more difficult to allege.

The Court's reasoning that the securities laws are aimed at remedying and deterring conduct only where actual loss proximately follows also suggests that loss causation must be pleaded and proved in actions other than those under Section 10b. For example, in cases under the Williams Act's best price rule, plaintiffs claim that one or more shareholders — usually insiders — received a higher price for their shares than other shareholders, usually due to the payment of severance or non-compete amounts that plaintiffs argue were a disguised share premium. But if plaintiffs fail to plead and prove that the offeror actually would have offered the premium to all shareholders, there would be no loss causation. Indeed, there would be no actual loss. The *Dura Pharmaceuticals* opinion suggests strongly that loss causation is a necessary element of a best price rule claim and that no damages can be recovered absent proof that the offeror would have paid the amount in question to all shareholders of record.

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