

## Supreme Court Grants Certiorari Regarding Loss Causation Pleading Requirement

On June 28, 2004, the U.S. Supreme Court granted a petition for a writ of certiorari to resolve a split among the federal circuit courts regarding whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price.<sup>1</sup>

In *Broudo v. Dura Pharmaceuticals, Inc.*, the U.S. Court of Appeals for the Ninth Circuit held that "loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise."<sup>2</sup> The court held that the injury to the shareholder occurs at the time of her initial purchase at an inflated price allegedly due to fraud. The court explicitly rejected the prevailing view of the Third and Eleventh Circuits that merely pleading that a security was purchased at an artificially inflated price could not, standing alone, satisfy the loss causation requirement of Rule 10b-5 promulgated under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act").<sup>3</sup> In these circuits, the complaint must also

allege that the ultimate corrective disclosure of the allegedly material information was followed by a stock price drop.<sup>4</sup> This view is also supported by case law in the Second and Seventh Circuits.<sup>5</sup>

### Background

Dura Pharmaceuticals, Inc. ("Dura") was a developer and marketer of treatments for respiratory conditions. Between April 15, 1997, and February 24, 1998, Dura issued several press releases making statements indicating, first, rising sales of Dura's Ceclor CD antibiotic, and second, satisfactory development and testing of Dura's Albuterol Spiros delivery device for Food and Drug Administration ("FDA") approval. During this period, Dura shares reached a high of \$53.<sup>6</sup>

On February 24, 1998, Dura revealed that it expected lower-than-forecast revenue due to slower than expected sales of Ceclor CD. The next day the stock plunged from \$39 1/8 to \$20 3/4.<sup>7</sup> Allegedly, Dura knew, as early as December 1997, that its wholesale channels were clogged with

<sup>1</sup> *Broudo v. Dura Pharm., Inc.*, 339 F.3d 933 (9th Cir. 2003), cert. granted, 124 S.Ct. 2904, 72 U.S.L.W. 3768 (U.S. June 28, 2004) (No. 03-932).

<sup>2</sup> 339 F.3d at 938.

<sup>3</sup> See *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000); *Robbins v. Koger Props, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997). Establishing loss causation is also a requirement under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737 which amended the Exchange Act to require 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." 15 U.S.C. 78u-4(b)(4).

<sup>4</sup> *Broudo*, 339 F.3d at 938, n.4 (citing *Semerenko*, 223 F.3d 165; *Robbins*, 116 F.3d 1441).

<sup>5</sup> See, e.g., *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003); *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 684-85 (7th Cir. 1990). However, the Eighth Circuit appears to be in agreement with the Ninth Circuit on this issue. See *Gebhardt v. ConAgra Food, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

<sup>6</sup> *Broudo*, 339 F.3d at 936.

<sup>7</sup> *Id.*

excess inventory and actual retail sales of Ceclor CD were declining. Dura's February announcement did not mention Albuterol Spiros.

Later, in November 1998, Dura announced that the FDA had decided to reject Albuterol Spiros due to health concerns. Following this second announcement, the price of Dura Stock initially dropped to \$9 3/4 from \$12 3/8, but apparently within 12 days was trading around \$12 1/2.<sup>8</sup>

Those shareholders who purchased Dura stock between April 15, 1997, and February 24, 1998, ultimately filed a consolidated, amended complaint alleging Dura made false and misleading statements about company performance and thereby violated, *inter alia*, Section 10(b) and Rule 10b-5.<sup>9</sup> Specifically, the complaint alleged that Dura hid the declining sales of Ceclor CD and the dwindling prospects for approval of Albuterol Spiros and continued to release positive and misleading communications.

After dismissing the Ceclor CD allegations because they were not sufficient to indicate that Dura's statements were made with scienter, the district court dismissed the claims regarding Albuterol Spiros for failure to adequately plead loss causation. In the district court's view, the FDA's non-approval, which was not announced until November 1998, had no causal connection to the February price drop.<sup>10</sup>

On appeal, the Ninth Circuit reversed and remanded. The court held that the plaintiffs were not required to establish a causal connection between a misrepresentation and a decline in stock price. Loss causation "merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause," because the injury occurs at the time of the transaction.<sup>11</sup> Therefore, to satisfy the element of loss causation under the Ninth Circuit test, securities plaintiffs need only plead that the price at the time of purchase was inflated due to misrepresentations and provide sufficient identification of the false statements that artificially increased the price. The Ninth Circuit found that the Dura shareholders could satisfy

<sup>8</sup> Brief of Amici Curiae The United States at 2, *Dura Pharm, Inc., et al. v. Michael Broudo* (2004) (No. 03-932), available at <http://www.usdoj.gov/osg/briefs/2003/2pet/6invit/2003-0932.pet.ami.inv.html>.

<sup>9</sup> The elements of a securities fraud claim under Section 10(b) include: (1) a false statement or omission with regard to a material fact; (2) made in connection with the purchase or the sale of a security; (3) with scienter; (4) upon which plaintiffs reasonably relied; and (5) which proximately caused the alleged loss. *See, e.g., Broudo*, 339 F.3d at 937.

<sup>10</sup> *Id.* at 938.

<sup>11</sup> *Id.*

the pleading requirement because the inflated price was arguably due in part to the misrepresentations of the Albuterol Spiros device during the time period they purchased the stock.<sup>12</sup>

The Ninth Circuit's view of loss causation is not shared by the Second, Third, Seventh, or Eleventh Circuits.<sup>13</sup> For example, in a relatively recent Second Circuit decision, *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*, the court held that the mere allegation that fraudulent omissions "induced a disparity between the price plaintiff paid for the . . . shares and their true investment quality" at the time of purchase "cannot satisfy the loss causation pleading requirement" because loss causation is the "causal connection between the content of the alleged misstatements or omissions and the harm actually suffered."<sup>14</sup> Likewise, the Third Circuit has held that because a plaintiff alleging securities fraud must prove that he or she suffered an actual economic loss, the plaintiff must also establish that the alleged misrepresentations proximately caused the decline in the investment's value in order to satisfy the element of loss causation.<sup>15</sup> In so holding, the Third Circuit remarked that "[i]n the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price."<sup>16</sup>

The Solicitor General filed an amicus brief in favor of the petition for a writ of certiorari.<sup>17</sup> Among other arguments, the Solicitor General highlighted the fact that the decision blurs the line between transaction causation and loss causation.<sup>18</sup> Transaction causation requires a finding that the violation caused the plaintiff to engage in the transaction, while loss causation requires a finding that the violation caused the harm for which monetary damages are sought.<sup>19</sup>

<sup>12</sup> *Id.*

<sup>13</sup> *See* notes 3 and 5 *supra*.

<sup>14</sup> 343 F.3d at 198 (internal quotations and citations omitted).

<sup>15</sup> *Semerenko*, 223 F.3d at 185. *See also Bastian*, 892 F.2d at 684-85; *Robbins*, 116 F.3d at 1448.

<sup>16</sup> *Semerenko*, 223 F.3d at 185.

<sup>17</sup> Brief of Amici Curiae The United States at 15.

<sup>18</sup> *Id.* at 11. *See also Emergent Capital*, 343 F.3d at 198 (noting that plaintiffs' "'investment quality' allegation amounts to nothing more than a paraphrased allegation of transaction causation").

<sup>19</sup> Brief of Amici Curiae The United States at 11-12.

## Considerations Going Forward

The ruling in this case could have significant implications for issuers, especially high-tech and biotech companies whose stock tends to be more volatile. As noted in the Solicitor General's brief in support of the petition for a writ of certiorari, if the Ninth Circuit decision is upheld by the Supreme Court so that a plaintiff relying on the fraud-on-the-market theory is not required to plead a loss of value attributable to the fraud, more securities class actions will likely pass the pleading stage.<sup>20</sup> This, in turn, will require "issuers of securities to expend time and resources litigating, and in most cases settling, such lawsuits" which, in the end, "is more likely to harm than to aid the 'intended beneficiaries' of Rule 10b-5" (i.e., the company's investors).<sup>21</sup>

<sup>20</sup> *Id.* at 14-15.

<sup>21</sup> *Id.* (citing *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994)).

The Ninth Circuit holding also has the potential to award a windfall to an investor who purchases and sells at a loss but before the misrepresentation is revealed and, therefore, while the stock price is still arguably inflated. Measuring the loss to investors at the time of the purchase, as the Ninth Circuit does, could give more compensation to these former shareholders "because they would recover the portion of the purchase price attributable to the fraud on resale, and then would be entitled to recover that same amount again in damages."<sup>22</sup>

We understand that the Supreme Court will hear oral arguments on this case in the fall of 2004 and render its decision before July 2005.

<sup>22</sup> Brief of Amici Curiae The United States at 11.

## Practice group contacts

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