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SUPREME COURT CURBS SECURITIES CLASS ACTION ABUSE

(Dura Pharmaceuticals v. Broudo)

The Washington Legal Foundation (WLF) scored a victory this week when the U.S. Supreme Court reversed a ruling from the U.S. Court of Appeals for the Ninth Circuit that had allowed a more relaxed pleading standard for attorneys filing securities class action cases against publicly-held companies. The Court's ruling is expected to curb abusive class action cases that often resulted in windfall damage awards and had been particularly damaging to smaller high-tech companies such as those in the life sciences industry.

In *Dura Pharmaceuticals v. Broudo*, the company released a report in February 1998 indicating that its earnings would be down. Consequently, the price of the stock dropped approximately 47%. Ten months later, the company reported that the Food and Drug Administration (FDA) refused to approve an inhaler that the company had intended to market; however, the price of the stock did not decline on the bad news. Nevertheless, noted California class action attorney Bill Lerach sued on behalf of shareholders claiming that the company knew about the FDA problems months earlier but failed to disclose that information in a timely fashion; therefore, he argued, they should be entitled to be compensated from the drop in the price of the stock, even though that price drop was caused by other factors.

In its brief, WLF argued that Congress enacted the Private Securities Litigation Reform Act (PSLRA) in 1995 to prevent class action attorneys from filing such abusive securities fraud cases against a company simply because the price of the stock went down. The PSLRA requires counsel to show that the loss from the drop in stock price was due directly to the alleged misrepresentation by the company rather than simply claim that the plaintiffs purchased the stock during the time of the alleged misrepresentation.

The Supreme Court agreed with WLF's argument. In a unanimous opinion written by Justice Stephen Breyer, the Court held that an inflated purchase price of stock will not by itself constitute or cause the relevant economic loss suffered by stockholders that is needed to allege and prove "loss causation." The Ninth Circuit had liberalized the pleading requirements by ruling that an inflated purchase price "touches upon" a later economic loss to the stockholder. The Supreme Court sharply criticized this broad standard, particularly because Congress intended to allow the filing of private securities fraud actions only where plaintiffs adequately allege and prove the traditional elements of cause and loss. As the Court noted, there could be many reasons why the price of a stock will drop that have nothing to do with the alleged

misconduct of the company. The securities law was not designed to be an insurance policy to protect investors from any drop in the price of their stock.

In addition, the Court held that while the general pleading requirements are quite liberal under the Federal Rules of Civil Procedure, it was insufficient to simply allege that the stock price is artificially inflated because such an allegation does not necessarily mean there is any economic loss. Accordingly, litigants must plead and prove proximate causation that more directly ties the economic loss to the alleged misconduct. Otherwise, the intent of Congress to limit abusive securities class action filings would be thwarted.

WLF's brief was drafted with the *pro bono* assistance of Michael L. Kichline, David A. Kotler, and John J. Sullivan of Dechert LLP from both the Philadelphia, Pennsylvania and Princeton, New Jersey offices.

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For information, contact WLF Senior Executive Counsel Paul Kamenar at 202-588-0302. A copy of WLF's brief is posted on WLF's website at www.wlf.org.