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LOWER COURTS WILL DETERMINE IMPACT OF SUPREME COURT'S SECURITIES FRAUD SUIT RULING

by

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The market crash of 2000-01 and a series of highly-publicized corporate accounting and underwriting scandals have led to an increase in securities fraud cases asserting novel theories of liability. As a result, one of the most heavily-litigated issues in securities litigation over the past few years has been loss causation – the requirement that plaintiffs plead facts showing that the alleged fraud caused them economic loss. Indeed, during that time, courts have issued dozens of decisions addressing the pleading standards for loss causation, but adopted varying approaches to the issue. The result has been a closely-watched judicial debate on the subject and a circuit split.¹

On April 19, 2005, the U.S. Supreme Court stepped into this fray with its unanimous decision in *Dura Pharms., Inc. v. Broudo*, __ U.S. __, 125 S. Ct. 1627 (2005). The Court held that a plaintiff must prove a causal link between any alleged fraud and a plaintiff's economic loss, and rejected the U.S. Court of Appeals for the Ninth Circuit's rule that would have allowed the plaintiff to proceed with his lawsuit by merely alleging that the purchase price of his stock had been inflated by the alleged fraud. While the Court's decision closed one chapter in the judicial debate, it may have opened a new one. The Court specified the overall standard for loss causation, but left open questions as to how that standard should be implemented — questions that will be the subject of extensive litigation in the lower courts.

Loss Causation and Rule 10b-5 Claims. Loss causation is simply the requirement that the plaintiff demonstrate the alleged fraud caused him to suffer an economic loss. *See* 15 U.S.C. § 78u-4(b)(4). Most federal securities fraud actions are brought under Rule 10b-5 (a rule promulgated by the Securities and Exchange Commission pursuant to section 10(b) of the Securities Exchange Act of 1934). Rule 10b-5 prohibits, among other things, the making of misleading statements or omissions of material fact in connection with the purchase or sale of any security. In a Rule 10b-5 case, the plaintiff must allege specific facts showing that “the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that plaintiff's reliance on

¹This judicial debate is the subject of a prior article by the authors. *See* “Pleading Loss Causation: The Supreme Court Dives into the Murky Waters of Securities Litigation,” Lyle Roberts, Paul Chalmers, and Gerard Stegmaier, WLF LEGAL BACKGROUNDER, Sept. 10, 2003.

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defendant's action caused injury to the plaintiff.” *Lawrence v. Cohn*, 325 F.3d 141, 147 (2d Cir. 2003) (internal quotations and citations omitted).

Courts have broken the causation requirement into two separate and distinct elements, both of which must be pled and proven: transaction causation and loss causation. Transaction causation requires proof that the alleged misconduct induced the plaintiff to engage in the transaction in question. It is equivalent to the actual or “but for” causation in tort law. Loss causation, on the other hand, is established by proof that the alleged misconduct caused the plaintiff's economic loss.

The Circuit Split. Though loss causation has not been a heavily litigated issue in the past, the issue has moved to the foreground recently. The extraordinary rise and crash of the stock market over the past few years, coupled with a series of corporate accounting and underwriting scandals, has led to a flurry of lawsuits alleging novel theories of fraud. As a result, courts have grappled with an essential question: did the defendants cause the identified losses or were they the result of market forces? Beginning with the controversial decision two years ago in *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003) *aff'd*, 396 F.3d 161 (2d Cir. 2005), dismissing several securities fraud complaints based on allegedly biased research reports on loss causation grounds, a host of courts reexamined the meaning of loss causation and, critically, the role it plays at the pleading stage. No fewer than three circuit courts of appeals – including the Ninth Circuit in *Broudo v. Dura Pharms., Inc.*, 339 F.3d at 933 (9th Cir. 2003), the decision the Supreme Court reversed – issued opinions reaffirming or clarifying their requirements for pleading loss causation, in the process bringing a circuit split into sharp relief.

Specifically, the courts adopted one of two conflicting approaches to loss causation. The first, adopted by the Eight and Ninth Circuits, is the price inflation approach. *See also Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824 (8th Cir. 2003). Under this approach, the court focuses on the moment the plaintiff purchased his security. If the plaintiff can show that his purchase price was inflated due to the defendants' misconduct, he has established loss causation, and he need not allege a subsequent price decline.

The second approach, followed by the Second, Third, Seventh, and Eleventh Circuits, is the price decline approach.² Under this approach, not only must the plaintiff show that the defendants fraudulently inflated the stock price at the time of his purchase, he must also show that he lost some or all of his overpayment, usually by alleging a corrective price decline after revelation of the fraud.

Dura – The Lower Courts' Rulings. In *Broudo*, the plaintiff alleged that the defendants made misleading statements about clinical trials needed for FDA approval of Dura's Albuterol Spiros asthma medication delivery device. On February 24, 1998, Dura revealed that it expected lower than forecast 1998 revenues and 1998 earnings per share, causing Dura's stock price to decline by 47%. The announcement did not mention the Albuterol Spiros delivery system, and it was not until November 1998, nearly nine months after the end of the class period, that Dura announced the FDA had “found the Albuterol Spiros device not approvable. . . .” *Broudo*, 339 F.3d 936. The district court found that the plaintiffs had failed to properly plead loss causation because the complaint did “not contain any allegations that the FDA's non-approval [of the Albuterol Spiros device] had any relationship to the February price drop.” *Id.* at 937.

The Ninth Circuit reversed. It held that the plaintiffs did not need to allege “that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the

²*See, e.g., Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003); *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000); *Bastian v. Petren Res. Corp.*, 892 F.2d 680 (7th Cir. 1990); *Roots P'ship v. Lands' End, Inc.*, 965 F.2d 1411 (7th Cir. 1992); *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997).

time of the transaction.” *Id.* at 938 (citation omitted). In a “fraud on the market case,” loss causation “merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause.” *Id.*

Dura – The Supreme Court’s Decision. The Supreme Court, in turn, reversed the Ninth Circuit, rejecting the court’s price inflation theory. Instead, the Supreme Court held that a plaintiff must plead and prove that there was a causal connection between the alleged misrepresentations and a subsequent decline in the stock price. *Dura*, 125 S. Ct. at 1631. In explaining its decision, the Court dismissed the idea that price inflation is the equivalent of an economic loss. The Court noted that “as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value.” *Id.* (emphasis in original). Moreover, it is not inevitable that an initially inflated purchase price will lead to a later loss. A subsequent resale of the stock at a lower price may result from “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events which, taken separately or together, account for some or all of that lower price.” *Id.* at 1632.

The Court also found that the price inflation theory has no support in the common law. The common law has “long insisted” that a plaintiff in a deceit or misrepresentation action “show not only that had he known the truth he would not have acted but also that he suffered actual economic loss.” *Id.* Accordingly, it was “not surprising that other courts of appeals have rejected the Ninth Circuit’s ‘inflated purchase price’ approach.” *Id.* (citations omitted).

Finally, the Court noted that the price inflation theory of loss causation was arguably at odds with the objectives of the securities statutes, including the Private Securities Litigation Reform Act of 1995 (“PSLRA”). *Id.* at 1633. The statutes make private securities fraud actions available “not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.” *Id.* In particular, the PSLRA “makes clear Congress’ intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss.” *Id.*

Impact of Dura. *Dura* supports the dismissal of cases where the drop in stock price cannot be linked to the substance of the alleged misrepresentations. The exact impact of *Dura*, however, will depend on: (1) the facts before the court; and (2) the procedural posture of the case.

Many securities fraud claims provide a direct link between the alleged fraud and a stock price decline. For example, if a company announces a financial restatement and the announcement leads to a stock price decline, plaintiffs will have little difficulty establishing that the stock price decline was related to the earlier financial misstatements. Other cases, however, will present more challenging factual scenarios. In the research analyst cases, for example, the investors’ losses generally resulted from the overall market crash, with any corrective disclosure concerning analyst conflicts occurring only later.³

In those cases where *Dura* is relevant, its impact will potentially be felt at several stages during litigation. The motion to dismiss is often the key event of a securities fraud case because if the complaint is not dismissed, it is usually settled, in large part because of the enormous costs and risks of bringing these cases to trial. *Dura* makes clear that a complaint should be dismissed where the plaintiff

³Indeed, for this reason, the Second Circuit, in a decision handed down prior to *Dura* but applying the standard adopted by the Supreme Court, affirmed the dismissal of securities fraud claims against Merrill Lynch research analysts. *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005).

has not pled facts linking a decline in the price of his securities to the defendant's alleged misrepresentations.

The exact nature of the plaintiff's pleading burden, however, is not spelled out. First, *Dura* does not directly address whether the stock price decline must be the result of a corrective disclosure that reveals the "truth" to the market. The Court makes some opaque references to when "the relevant truth begins to leak out" and "when the truth makes its way into the market place," 125 S. Ct. at 1631-32, but does not clarify whether plaintiffs can simply allege that any drop in stock price during the class period was attributable to misstatements.

Second, the Court declined to address whether the PSLRA or Federal Rule of Civil Procedure 9(b) impose a heightened pleading burden for loss causation. Because Broudo's allegations were insufficient even under FED. R. CIV. P. 8's "short and plain statement" requirement, the Court "assume[d], at least for arguments sake," that neither the PSLRA nor 9(b) impose "any special further [pleading] requirement" as to loss causation. *Dura*, 125 S. Ct. at 1634. Even under notice pleading, the Court stated, "it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind." *Id.* Broudo's counsel has seized on this portion of the opinion to claim victory — despite the Court's unanimous reversal of a decision favorable to his client — because "they didn't raise the hurdle on us." *Supreme Court Declines to Ease Standards on Claims*, SAN DIEGO UNION TRIBUNE, Apr. 20, 2005, at C1. More accurately, however, the Court left the exact setting of the hurdle to the lower courts. In sum, while *Dura* improves a defendant's ability to obtain a dismissal based on loss causation, the extent to which it does so is unclear and will require further judicial clarification.

Should the motion to dismiss be denied, *Dura* may affect class certification decisions. For class certification to be proper, the plaintiff must show, *inter alia*, that common issues predominate over individual ones. FED. R. CIV. P. 23(b). Thus, the plaintiff "must present a methodology for determining loss causation that may be commonly applied to all members of the class." *In re Initial Public Offering Sec. Litig.*, 227 F.R.D. 65, 111 (S.D.N.Y. 2004). Under *Dura*, this means that the plaintiff must provide a mechanism for showing that the alleged misrepresentation caused a price decline that affected all class members. *Id.* at 111-12. Class members whose shares were not so affected (*e.g.*, they sold before the decline or bought afterwards) would be differently situated, meaning loss causation would not be a common issue. *Id.*

Finally, *Dura* will have an impact on cases that reach summary judgment and beyond. Although the Court noted that a variety of factors, besides an alleged fraud, could cause a stock price decline, 125 S. Ct. at 1632, it did not provide guidance as to how plaintiffs can meet their burden of proof for loss causation in cases where some or all of these other factors are present. To put it another way, the Court called for a "battle of the experts" without establishing any rules of engagement. Again, as a result, lower courts have been left to sort out how loss causation can be proven with any precision.

In sum, defendants in the Eighth and Ninth Circuits will breathe a sigh of relief with the demise of the price inflation theory, and future defendants may generally be more reluctant to settle, even following a motion to dismiss loss, given the availability of potentially attractive loss causation arguments. Predicting the long-term impact of *Dura* is difficult, however, because the Court's narrow decision leaves a number of pleading and proof issues for the lower courts to resolve.