

# THE SUPREME COURT CLARIFIES PLAINTIFFS' BURDEN OF DEMONSTRATING LOSS CAUSATION IN SECURITIES FRAUD CASES

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On April 19, 2005, the United States Supreme Court issued a decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 541 U.S. 901, 125 S.Ct. 1627, 2005 WL 885109 (April 19, 2005), which resolved a split among the Circuit Courts of Appeals and held that securities class action plaintiffs must meet a stringent burden of proof with respect to the required element of "loss causation" in securities fraud actions brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The Supreme Court reversed a decision of the Ninth Circuit Court of Appeals, finding that it had applied an illogical loss causation standard and reinstated the trial court's earlier dismissal of claims based on the failure to adequately plead loss causation.

## The Loss Causation Issue & The Previous Circuit Split

A plaintiff suing under Rule 10b-5 must demonstrate each of the required elements of the claim: (1) a misstatement or omission, (2) of material fact, (3) made with intent to defraud, (4) on which the plaintiff relied, (5) and which proximately caused the plaintiff's injury. The last of these elements, commonly referred to as "loss causation," requires the plaintiff to prove not only that, had he known the truth he would not have purchased the securities, but also that the alleged untruth in some reasonably direct way caused his loss.

Until now, a split of the circuits existed relating to how loss causation must be pled and proven. A majority of the circuits required a plaintiff to prove not only that the alleged misrepresentations inflated the price of the company's stock, but also that there was later a revelation of the truth that resulted in a drop in the stock price.<sup>1</sup> A minority of circuits, including the Ninth Circuit in *Dura Pharmaceuticals*, held that loss causation could be established merely by showing that the stock price

<sup>1</sup> See *Emergent Capital Investment Management, L.L.C. v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d. Cir. 2003); *Semerenko v. Candant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000); *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir. 1990); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997).

was artificially inflated at the time of purchase, regardless of whether there was a later price drop following disclosure of the truth.<sup>2</sup>

## The Dura Pharmaceuticals Case

In *Dura Pharmaceuticals*, the plaintiffs alleged that defendants "artificially inflated" the company's stock price by, among other things, falsely claiming that they expected the Food and Drug Administration ("FDA") to soon grant approval of a new asthmatic spray device.<sup>3</sup> According to the plaintiffs, this artificial inflation continued until February 1998, when the company announced that it was downwardly revising its previous earnings forecasts, and the value of its stock declined by almost half. The plaintiffs' complaint, however, did not allege that the February 1998 announcement revealed anything about the status of FDA approval of the spray device, and in fact, the FDA's ultimate non-approval of the device was not announced until eight months later, in November 1998.<sup>4</sup> Upon that later announcement, the company's stock price "temporarily fell, but almost fully recovered within one week."<sup>5</sup>

The trial court dismissed the spray device claim based on the absence of loss causation, finding that the plaintiffs had failed to plead any nexus between the alleged spray device misrepresentations and any decline in company stock after the February 1998 disclosure.<sup>6</sup> The Ninth Circuit, however, reversed the dismissal, holding that a plaintiff meets its burden of pleading loss causation by alleging that the stock price was artificially inflated at the time of purchase.<sup>7</sup>

<sup>2</sup> See *Broudo v. Dura Pharms., Inc.*, 339 F.3d 933, 938 (9th Cir. 2003); *Gebhart v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

<sup>3</sup> *Dura Pharmaceuticals*, 125 S.Ct. 1627, 1630 (2005).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> See *Broudo v. Dura Pharms., Inc. Litig.*, No. 99CV0151-L, slip. op. (S.D. Cal. Nov. 2, 2001).

<sup>7</sup> See *Broudo v. Dura Pharms., Inc.*, 339 F.3d at 938 (9th Cir. 2003).

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## The Supreme Court's Decision

In a unanimous decision, the Supreme Court reversed the Ninth Circuit, holding that it had applied the wrong standard. The Court emphasized that the federal securities laws are "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause."<sup>8</sup> According to the Court, in a typical securities fraud case, "an inflated purchase price will not itself constitute or proximately cause the relevant loss."<sup>9</sup> To illustrate why this was so, the Court noted, for example, that if an investor purchased stock at an inflated price and later sold those shares "quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss."<sup>10</sup> The Ninth Circuit's standard impermissibly would have allowed recovery in this circumstance, even though the required element of loss causation would be missing.<sup>11</sup>

The Court ruled that in a case, like *Dura Pharmaceuticals*, that was predicated on the "fraud-on-the-market" theory, the requisite causal connection would not be made absent a showing that the stock price declined after disclosure of the truth concerning the particular alleged misrepresentation at issue.<sup>12</sup> To satisfy his burden at the pleading

stage, a plaintiff is required to indicate in his complaint a specific economic loss he suffered and the causal connection between that loss and the alleged misrepresentation. Noting the "complaint's failure to claim Dura's share price fell significantly after the truth [regarding the FDA approval of the spray device] became known," the Court held that the plaintiffs' claims were properly dismissed by the trial court because of the absence of loss causation.<sup>13</sup>

## Conclusion

The Supreme Court's decision in *Dura Pharmaceuticals* provides much needed guidance on a previously unsettled area of law. The decision clarifies that a securities fraud claim may not be grounded simply on a loss experienced in an investment, but only those losses shown to be causally connected to the specific misrepresentations alleged.



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<sup>8</sup> See *Dura Pharmaceuticals*, 125 S.Ct. at 1633 (emphasis added).

<sup>9</sup> *Id.* at 1631.

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

<sup>11</sup> See *id.*

<sup>12</sup> See *id.* at 1632 (citing approvingly the "judicial consensus" reflected in the Restatement of Torts that securities fraud liability extends only "for the loss the purchaser sustains when the facts . . . become generally known and as a result share value depreciate[s]") (internal quotations omitted); see also *id.* at 1631 (stating that if a purchaser sells his shares "before the relevant truth begins to leak out, the misrepresentation will not have led to any loss").

<sup>13</sup> *Id.* at 1634.