

THE SECURITIES EXCHANGE COMMISSION WEIGHS IN FOR THE DEFENSE ON IMPORTANT ISSUE OF PRIVATE SECURITIES LITIGATION

By: Thad Behrens and Matt Chester

Presently pending before the United States Supreme Court is the case of *Dura Pharmaceuticals, Inc., et al., v. Michael Broudo, et al.*, No. 03-932, which involves an appeal of a trial court's dismissal of a securities fraud class action. The *Dura Pharmaceuticals* case is being watched closely by securities class action lawyers around the country as the merits of the appeal focuses on the manner in which the required element of "loss causation" must be pled and proven in securities fraud class actions brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The Supreme Court's eventual ruling, if it were to adopt the arguments of the defendants, would circumscribe the ability of plaintiffs to assert claims based on intentional misrepresentations where they could not show that the company's stock price declined when the "truth" was later revealed.

The defense's arguments on the loss causation issue received a boost in the form of an amicus brief submitted by an unlikely ally, the Securities Exchange Commission ("SEC"). It is rare for the SEC to enter the fray of private securities litigation at all, and especially on an issue like loss causation that is not an element the SEC must prove in its enforcement actions. Moreover, it is unique that the SEC took a position opposing the securities plaintiffs' bar, with whom the SEC's interests are typically aligned. The SEC nevertheless believed it necessary to weigh in on the subject, explaining that:

"[p]rivate securities-fraud actions are an essential supplement to criminal prosecutions and civil enforcement actions brought [by the government], and the United States has a strong interest in seeing that the principles

applied in such actions promote the purposes of the securities laws."¹

The Loss Causation Issue

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.² 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 acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss."³

While there is no dispute that loss causation is a separate required element of a Rule 10b-5 claim, there is a split among the U.S. Courts of Appeals as to how loss causation must be shown. A majority of the circuits require 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.⁴ A minority of circuits,

¹ Brief for The United States as Amicus Curiae, *Dura Pharm., Inc. v. Broudo*, 2004 WL 2069564 at *1 (Sept. 13, 2004) (No. 03-932) (*hereinafter* "SEC Merits Brief").

² *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 406-07 (5th Cir. 2001).

³ *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *rev'd in part on other grounds*, 459 U.S. 375, 103 S. Ct. 683 (1983); *see also* 15 U.S.C. § 78u-4(b)(4) (plaintiff must prove that the alleged fraud "caused the loss for which the plaintiff seeks to recover damages").

⁴ *See Emergent Capital Investment Management, L.L.C. v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003); *Semerenko v. Cendant 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)

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including the Ninth Circuit from which the appeal in the *Dura Pharmaceuticals* was taken, hold that loss causation is established merely by showing that the stock price was artificially inflated at the time of purchase, regardless of whether there was later a price drop following disclosure of the truth.⁵ The split will now be resolved by the Supreme Court in *Dura Pharmaceuticals*.

The *Dura Pharmaceuticals* Case

The *Dura Pharmaceuticals* case is a fairly ordinary Rule 10b-5 putative class action, with customary allegations that the defendants made misrepresentations that artificially inflated the price of *Dura Pharmaceuticals* stock during the class period.⁶ The plaintiffs' complaint asserted that the company's press releases misrepresented the sales of its popular drug, Ceclor CD, as well as the likelihood of FDA approval for its new medical device, Albuterol Spiros.⁷

The plaintiffs alleged that these misrepresentations artificially inflated the stock price until February 1998, when the company announced a revenue shortfall.⁸ The February 1998 press release revealed nothing about the status of FDA approval of the Albuterol Spiros, however.⁹ In fact, the FDA's ultimate refusal to approve the Albuterol Spiros was not disclosed until nine months later.¹⁰ Defendants argued that the plaintiffs failed to show loss causation because there was no possible nexus between

the alleged misrepresentations and omissions about Albuterol Spiros and the decline in *Dura Pharmaceutical's* value after the February 1998 press release.¹¹

The district court dismissed the action for failure to state a claim in part on the ground that plaintiff failed to plead loss causation. The Ninth Circuit, however, subsequently reversed the district court's dismissal, and held that damages are to be calculated at the time of the purchase, not after any corrective disclosure is made.¹² The company thereafter filed a petition for writ of certiorari, which was supported by an amicus brief from the SEC,¹³ challenging the Ninth Circuit's standard of loss causation. The Supreme Court granted the petition on June 28, 2004.¹⁴

The SEC's Participation in the Supreme Court Proceedings

Following its amicus brief in support of the defendants' petition for writ of certiorari,¹⁵ the SEC filed another brief in support of the defendants' position on the merits of the appeal.¹⁶ In its brief, the SEC specifically argued that the Ninth Circuit had applied the wrong standard for loss causation,¹⁷ explaining:

Determining loss at the time of purchase would grant a windfall to investors who sold before the reduction or elimination of the artificial inflation, because they would recover the portion of the

⁵ 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).

⁶ See *Broudo v. Dura Pharms., Inc. Litig.*, No. 99CV0151-L, slip. op. at 2-3 (S.D. Cal. Nov. 2, 2001).

⁷ See *Broudo*, No. 99CV0151-L, slip. op. at 11-20; see also *Broudo*, 339 F.3d at 935.

⁸ See *Broudo*, 339 F.3d at 935-37.

⁹ *Id.*

¹⁰ See *id.* at 936.

¹¹ See *Broudo*, No. 99CV0151-L, slip. op. at 15.

¹² See *Broudo*, 339 F.3d at 938.

¹³ See Brief for the United States as Amicus Curiae, 2004 WL 1205204 (May 28, 2004) (No. 03-932) (*hereinafter* "SEC Cert. Brief").

¹⁴ *Dura Pharmaceuticals, Inc. v. Broudo*, 124 S.Ct. 2904 (2004).

¹⁵ See SEC Cert. Brief, 2004 WL 1205204.

¹⁶ SEC Merits Brief, 2004 WL 2069564 at *1.

¹⁷ See SEC Merits Brief, 2004 WL 2069564 at *21-29.

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purchase price attributable to the fraud on resale, and then, under the Ninth Circuit's logic, would be entitled to recover that same amount again as damages for the loss.¹⁸

According to the SEC, the Ninth Circuit's standard also rendered loss causation effectively indistinguishable from the separate, independent element of reliance in a fraud-on-the-market case.¹⁹

The SEC further contended that a plaintiff asserting a Rule 10b-5 claim should not be able to plead loss causation in mere conclusory terms. Instead, "because loss causation is an element of a fraud cause of action, the allegations must be 'stated with particularity.'"²⁰

The Supreme Court heard oral argument on the case on January 12, 2005. The Deputy Solicitor General, on behalf of the SEC, appeared and was heard, adding further support to the defendants' position.²¹ A decision in the case is expected later this Spring. While it is difficult to predict how the Supreme Court will rule, the Justices no doubt will carefully consider the views of the SEC as the agency charged with enforcing the Nation's securities laws.



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¹⁸ SEC Merits Brief, 2004 WL 2069564 at *23.

¹⁹ SEC Merits Brief, 2004 WL 2069564 at *23-24.

²⁰ SEC Merits Brief, 2004 WL 2069564 at *15 (citing FED. R. CIV. P. 9(b)).

²¹ *Dura Pharms., Inc., et al. v. Broudo, et al.*, Oral Argument at 18-27 (Jan. 12, 2005) (No. 03-932).