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NEW SUPREME COURT RULING IMPOSES SIGNIFICANT HURDLE FOR SHAREHOLDERS PURSUING SECURITIES FRAUD CLAIMS

This morning the United States Supreme Court issued an eagerly awaited opinion in *Dura Pharmaceuticals, Inc. v. Broudo*, 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 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 impermissibly lax and illogical loss causation standard, and reinstated the trial court’s earlier dismissal of claims based on the failure to adequately plead loss causation. The *Dura Pharmaceuticals* decision is important news for public companies and their directors and officers because it restricts shareholder plaintiffs from predicating a securities fraud claim on a stock price decline that has no causal nexus to some earlier alleged “misstatement.” The decision should provide fertile grounds for future dismissals and/or summary judgments in securities cases.

The Previous Circuit Split on Loss Causation


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, which courts refer 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, there has been a split of authority as to how loss causation must be pled and proven. A majority of Circuit Courts of Appeals have 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. A minority of Circuits, including the Ninth Circuit in the *Dura Pharmaceuticals* case, have held 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 stock price drop following disclosure of the truth. The Supreme Court has now rejected the plaintiff-friendly, minority view.

The Underlying *Dura Pharmaceuticals* Case

The plaintiffs complaint in *Dura Pharmaceuticals* alleged several misrepresentations, but the only ones relevant to the Supreme Court appeal were alleged misstatements regarding the company’s expectation that the FDA would soon approve a new asthmatic spray device it had manufactured. The plaintiffs alleged that Dura Pharmaceuticals’ stock price was artificially inflated by the spray device misrepresentations until February 1998, when the company announced that its earnings would be lower than previously expected.

The problem for plaintiffs, however, was that the February 1998 announcement said nothing about the status of FDA approval of the spray device. In fact, the FDA’s ultimate refusal to approve the spray device was not announced until nine months later, in November 1998. The trial court therefore dismissed the spray device claim based on the absence of



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loss causation, finding that the plaintiffs had failed to plead any nexus between the alleged spray device misrepresentations and the decline in Dura Pharmaceutical's value after the February 1998 press release.

The Ninth Circuit reversed, however, holding that a plaintiff's "injury occurs at the time of the transaction," and thus, "plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." Because plaintiffs had made such an allegation in the complaint, the Ninth Circuit held that dismissal was inappropriate.

The Supreme Court's Decision

In a unanimous decision, the Supreme Court reversed the Ninth Circuit and held that it had applied the wrong loss causation standard. The Court held that in a typical securities fraud case, "an inflated purchase price will not itself constitute or proximately cause the relevant loss." 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." The Ninth Circuit's purchase-price inflation standard impermissibly would have allowed recovery even where the required element of loss causation was "missing."

Moreover, the Court recognized that even for investors who sold for less than what they paid after the "truth" was revealed, loss causation would not necessarily be established by a showing that the price was artificially inflated at the time of purchase. The Supreme Court noted that a lower selling price may be caused, not by the alleged misrepresentation, but rather by "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events" that may "account for some or all of that lower price." In fact, the Court observed, "the longer the time between purchase and sale, the more likely that this is so, *i.e.*, the more likely that other factors caused the loss."

The Court held that shareholder plaintiffs must indicate in their pleadings a specific economic loss they suffered and the causal connection between that loss and the alleged misrepresentation. According to the Court, allowing a plaintiff to forego such a pleading requirement "would permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence. Such a rule would tend to transform a private securities action into a partial downside insurance policy."

A copy of the Supreme Court's opinion is available at www.supremecourtus.gov/opinions/04pdf/03-932.pdf.

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