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Landmark Supreme Court Decision Raises Standard for Plaintiffs in Securities Fraud Class Actions

by William F. Sullivan, Christopher H. McGrath and Tracey L. DeLange

On April 19, 2005, the United States Supreme Court issued a landmark decision in Dura Pharmaceuticals v. Broudo, raising the bar for plaintiffs in securities fraud class actions. By many accounts, this is the most important decision in securities fraud litigation in more than a decade by the Supreme Court. In addition to heightening the threshold a shareholder must meet before suing to recoup for stock market losses, the ruling provides companies that are sued in securities class actions with an important tool in defending expensive and often unmeritorious cases brought after stock prices fall for reasons unrelated to any wrongdoing. The significance of this Paul Hastings victory is further underscored by the fact that the shareholders in this case were represented by one of the most prominent and successful plaintiffs securities class action law firms in the country.

In a unanimous decision issued by the United States Supreme Court, Paul Hastings attorneys successfully challenged and obtained reversal of the Ninth Circuit Court of Appeals' controversial ruling on "loss causation" in securities class actions. In *Dura Pharmaceuticals, Inc., v. Michael Broudo, et al.* 544 U.S. _____ (2005), the Supreme Court rejected a Ninth Circuit holding that a plaintiff in a securities fraud action can satisfy the "loss causation" requirement – *i.e.*, the requirement that plaintiff establish a causal connection between the defendant's misrepresentation and an economic loss – simply by alleging that the price of the stock *on the date of purchase* was inflated as a result of defendant's alleged misrepresentation. *See Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, 938 (2003). Justice Breyer stated "[the Ninth Circuit's] statement of the law is wrong." *Dura*, 544 U.S. ____ , slip op. at 5. The Supreme Court held that, in fraud-on-the-market cases, an "inflated purchase price will not by itself constitute or proximately cause the relevant economic loss" necessary to establish "loss causation." *Id.* Rather, the Supreme Court held, shareholders must establish a clear connection between a company's misrepresentations and a subsequent loss in stock value.

The Supreme Court's ruling is not only a tremendous victory for Paul Hastings' clients Dura Pharmaceuticals and its individually named officers and directors, but also for the securities industry, the securities litigation bar, the Office of the Solicitor General and the Securities Exchange Commission, all of which filed amicus briefs in the case urging the Court to reverse the Ninth Circuit's rule on "loss causation."

Background of the Dura Case

Dura Pharmaceuticals, Inc. ("Dura") was a San Diego-based developer and marketer of prescription pharmaceutical products for the treatment of allergies, asthma, and related respiratory conditions. The individual defendants in the case held various management or director positions with Dura. Plaintiffs are investors who purchased shares of Dura between April 15, 1997 and February 24, 1998 ("Class Period").

On February 24, 1998 Dura announced that it expected a revenue shortfall for the upcoming full year due to anticipated slow pharmaceutical sales, increased competition, and a need to increase Dura's sales force. The announcement said nothing about Albuterol Spiros, Dura's delivery device for asthma medication, which was in development in coordination with the United States Food and Drug Administration ("FDA"), and not yet FDA-approved. Following this announcement, Dura's stock dropped from $39.125 on February 24, 1998 to $20.75 on February 25, 1998, a 47% one-day loss.

On November 3, 1998, nearly nine months after Dura's February 24, 1998 announcement and the concurrent loss in stock price, Dura announced that the FDA did not approve Albuterol Spiros due to issues of electro-mechanical reliability and

the need for additional clinical trials. Dura's share price declined somewhat following the November 3, announcement, from $12.375 to $9.75. Within 12 trading days, however, the stock price fully recovered to $12.438, and within 90 days it closed at $14.00 per share.

Plaintiffs filed a Consolidated Amended Complaint ("CAC") on October 7, 1999, alleging that defendants made materially false statements during the Class Period regarding the prospects of Albuterol Spiros. Plaintiffs did *not* seek to recover losses associated with the November 3 announcement concerning Albuterol Spiros or the *temporary* decline following that announcement. Rather, plaintiff sought only to recover for the 47% decline in price that followed the previous February 24 announcement of an anticipated prospective revenue shortfall. On July 12, 2000, the district court granted defendants' motion to dismiss the CAC without prejudice, in part because plaintiffs failed to plead the requisite "loss causation" with respect to Albuterol Spiros.

On appeal, the Ninth Circuit reversed. As to the "loss causation" element of a securities fraud claim, the Ninth Circuit held "in a fraud-on-the-market case, plaintiffs establish loss causation if they plead that the stock price *on the date of purchase* was inflated because of the misrepresentation. . . . [I]t is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred. . . ." 339 F.3d at 938. As the Ninth Circuit believed, "the injury occurs at the time of the transaction" *Id.* According to the Ninth Circuit, it was not necessary that a disclosure and related subsequent drop in the market price of the stock have actually occurred. *Id.*

In late June 2004, Paul Hastings attorneys successfully petitioned the United States Supreme Court to review the Ninth Circuit's decision, arguing that the Ninth Circuit's decision of loss causation could not be reconciled with the decisions of other Circuits that have rejected this price inflation theory of loss causation, nor could the decision be reconciled with the plain language of the Private Securities Litigation Reform Act of 1995, which expressly imposes on plaintiffs "the burden of proving" that the defendant's misrepresentations "caused the loss for which the plaintiff seeks to recover." 15 U.S.C. § 78u-4(b)(4).

The "Loss Causation" Requirement

The basic elements of a private securities fraud action include pleading and proving *loss causation*. Loss causation was first articulated by the Second Circuit in 1974, and defined as a "showing" that the defendant's misrepresentations "caused the economic harm." *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974). In 1995, as part of its comprehensive effort to establish uniform and stringent pleading requirements in private securities fraud actions, Congress codified the "loss causation" requirement by enacting Section 21D(b)(4) of the Private Securities Litigation Reform Act of 1995, which provides that "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title *caused the loss for which the plaintiff seeks to recover damages*." 15 U.S.C. § 78u-4(b)(4).

The majority of Circuit Courts that had considered the "loss causation" issue had determined that, in order to establish loss causation, a securities fraud plaintiff had to plead and prove a causal connection between the alleged fraud and the investment's subsequent decline in value. By contrast, the Ninth Circuit only required a plaintiff to establish that the stock's value at the time of purchase was artificially inflated as a result of the defendant's alleged misrepresentation; no showing of a subsequent decline in price associated with the "artificial inflation" was necessary.

The Impact of the Supreme Court's Ruling

In rejecting the price inflation theory, the Supreme Court held that, "as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss" because the inflated purchase price is offset by ownership of stock that carries the equivalent value. 544 U.S. ____ , slip op. at 5. The Supreme Court noted the "logical link" between the artificially inflated purchase price and any subsequent loss in value "is not invariably strong." *Id.* A subsequent drop in stock price may reflect a number of other factors, conditions or events unrelated to any earlier misrepresentation. The securities fraud statutes are designed "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." *Id.* at 8. To allow plaintiffs to establish "loss causation" based on the artificial inflation theory alone "would bring about harm of the very sort the statutes seek to avoid," transforming "a private securities action into a partial downside insurance policy." *Id.* at 10-11.

This landmark decision clearly delineates a demanding and common-sense standard for proving and pleading loss causation in securities class actions. In addition to clarifying the threshold a shareholder must meet before suing to recoup for stock market losses, the ruling provides companies that are sued in securities class actions with an important tool in defending themselves in expensive and often unmeritorious cases brought simply because stock prices fall for reasons unrelated to any wrongdoing. We anticipate that securities cases currently pending throughout the federal court system will be reevaluated with regard to loss causation allegations, and that a fair number of motions to dismiss or motions for summary judgment will be brought based on this seminal decision by the Supreme Court.

Editor's note: Paul Hastings partner Bill Sullivan argued the case before the Supreme Court on January 12, 2005. Also on the brief were Chris McGrath and Tracey DeLange of Paul Hastings' San Diego office. The plaintiff shareholders in this case were represented by Lerach, Coughlin, Stoia and Robbins, LLP, one of the most prominent plaintiffs securities class action law firms in the country.

If you have any questions regarding the Supreme Court's decision or any other securities litigation matter, please do not hesitate to contact your Paul Hastings attorney, or the authors of this alert listed below:

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