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Supreme Court to Review Controversial Case Involving "Loss Causation" Issue in Securities Class Actions

William F. Sullivan, Christopher H. McGrath, Tracey L. DeLange and Meghan J. Atwood

Paul Hastings' attorneys have successfully petitioned the United States Supreme Court to review a controversial Ninth Circuit Court of Appeals decision that could negatively impact defendants in securities class actions based on the fraud-on-the-market theory. In the decision at issue, *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir. 2003), the Ninth Circuit held that the investor plaintiffs could satisfy the "loss causation" requirement, a required element of a Rule 10b-5 claim, by simply alleging that they overpaid for a company's stock due to alleged misrepresentations and without showing that the investors actually lost value because of the alleged misrepresentations. This decision is at odds with the Private Securities Litigation Reform Act of 1995 (the "PSLRA") and with the consistent holdings of other federal circuit courts of appeal that have addressed this same issue. The Ninth Circuit's holding has taken the "loss" out of "loss causation" and has opened a Pandora's Box where plaintiffs may pursue claims against companies alleging only that share prices are artificially inflated, without any corresponding decline whereby investors might have suffered actual harm. The Office of the Solicitor General, the Securities and Exchange Commission and the Securities Industry Association also have pushed for the review and reversal of the *Dura* decision.

Background of the Dura Case

This securities fraud case is a class action brought on behalf of investors who purchased Dura Pharmaceuticals, Inc. stock between April 15, 1997 and February 24, 1998. Dura issued a press release at the beginning of the alleged class period announcing the completion of certain clinical trials necessary for submission of a new drug application to the FDA for an asthma medication device, Albuterol Spiros. At the close of the alleged class period, February 24, 1998, Dura announced that it anticipated lower than forecast 1998 revenues and earnings per share mainly due to slower than expected sales of its Ceclor CD antibiotic. Dura did not mention its Albuterol Spiros device in this announcement. On the day following this press release, Dura's stock dropped 47 percent. In November of 1998, nearly nine months after the close of the alleged class period, Dura announced that the FDA had failed to approve Albuterol Spiros. Although Dura's stock price dropped somewhat following this November announcement, it recovered within twelve days.

In their complaint, the plaintiffs alleged that Dura's statements about Albuterol Spiros during the class period artificially inflated the stock price and were false and misleading in violation of Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5. In response, the defendants moved to dismiss the complaint on the ground that plaintiffs had not, and could not, plead a causal connection between any alleged misrepresentations about Albuterol Spiros and the decline in stock price at the close of the alleged class period.

The district court granted defendants' motion to dismiss, agreeing that the stock price drop that supposedly caused plaintiffs' injuries was not triggered by the alleged Albuterol Spiros misrepresentations.[1] In other words, with regard to the purported misrepresentations involving Albuterol Spiros, the district court found that plaintiffs had not adequately pleaded "loss causation." On appeal, the Ninth Circuit disagreed with the lower court's reasoning. Instead, the Ninth Circuit found that the element of "loss causation" was satisfied by allegations that the claimed misrepresentations touched upon the reasons for the stock's decline in value. Although the court admitted that the "touches upon" standard was ambiguous, it determined that a plaintiff in a fraud-on-the-market case can establish "loss causation" by showing that the price on the date of the purchase was inflated because of the misrepresentation. The court stated that "for a cause of

action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the transaction." Thus, according to the court, "loss causation" merely requires pleading that the price at the time of the purchase was overstated rather than pleading that the stock price dropped following a corrective disclosure. Based on this reasoning, the court found that plaintiffs' price inflation allegations passed the "loss causation" threshold and thus reversed the lower court's decision.

Dura's Potential Impact on Fraud-on-the-Market Securities Class Actions

As the Ninth Circuit admits, its decision in *Dura* is in conflict with other federal circuits which do require a corrective disclosure associated with a subsequent stock price drop to be alleged in the complaint. In fact, the Ninth Circuit's price inflation theory is in direct conflict with recent decisions of the Eleventh, Second and Third Circuits, all of which require a plaintiff to establish a causal connection between the alleged misrepresentation and a subsequent decline in stock price. The Ninth Circuit's interpretation of "loss causation" also cannot be reconciled with the text of the PSLRA. As required by the PSLRA, a plaintiff who brings a securities fraud claim has the burden of proving that the alleged fraud of the defendant caused the loss for which the plaintiff seeks to recover damages. In *Dura*, the loss for which plaintiffs seek to recover damages is the 47% price decline that occurred on February 25, 1998. According to the Ninth Circuit, however, plaintiffs do not need to allege that the alleged misrepresentations regarding Albuterol Spiros caused this loss. The Ninth Circuit's holding, thus, has serious implications since "loss causation" ensures the existence of an identifiable nexus between a defendant's alleged misconduct and a plaintiff's claimed losses.

In addition, the *Dura* decision runs counter to the "efficient market" theory that underlies all fraud-on-the-market securities class actions. According to the theory, in an efficient market, all publicly available material information about a company is rapidly reflected in the company's stock price. This theory allows an investor plaintiff to demonstrate "transaction causation" by claiming that a material misrepresentation artificially inflated the stock price and that the investor thus relied on the misrepresentation when purchasing at the market price.[2] The efficient market theory also affects the "loss causation" requirement. An artificially inflated stock price in an efficient market will remain inflated until the misrepresentations are disclosed. Under this theory, investors who buy and then sell at the artificially inflated prices – often referred to as "ins and outs"— incur no loss since the price inflation is absorbed in the transaction. In other words, economic loss does not occur until the misrepresentations are uncovered in the market and then reflected in the stock price. Any price decrease prior to a corrective announcement is thought to be caused by market conditions other than the alleged misrepresentations because the falsity is not yet known and thus cannot affect the stock price.

The Ninth Circuit's holding, however, cannot be reconciled with the efficient market theory as it fails to distinguish between the two separate elements of "transaction causation" and "loss causation." Under the Ninth Circuit's approach, plaintiffs will satisfy the pleading requirements for both "transaction causation" and "loss causation" merely by invoking the fraud-on-the-market theory, and alleging a material misrepresentation and artificial inflation of the stock price. By allowing a plaintiff to bring suit simply for purchasing stock that was purportedly artificially inflated at the time of purchase, the court's ruling serves as an insurance policy for every alleged misrepresentation made in connection with the purchase of a security. The Ninth Circuit's interpretation presumably would allow "in-and-out" traders to satisfy the pleading requirement for "loss causation" even where they have suffered no loss. Accordingly, the Ninth Circuit's ruling here has the potential to create an unprincipled windfall for many investors.

Although the requirements of PSLRA and the economic principles at stake indicate that the Supreme Court should reverse this decision, we will continue to report to our clients any important future developments in this area. For further information about the issues discussed in this client alert, please contact any member of our Securities Litigation Practice Group listed below:

In Atlanta

Allen Maines (408) 815-250
allenmaines@paulhastings.com

John Parker (404) 815-2222
johnparker@paulhastings.com

In Los Angeles

Eve Coddon (213) 683-6150
evecoddon@paulhastings.com

Howard M. Privette II (213) 683-6229
howardprivette@paulhastings.com

In New York

Gerald Fields (212) 318-6290
geraldfields@paulhastings.com

In New York (Cont.)

Kevin C. Logue(212) 318-6039
kevinlogue@paulhastings.com

In Orange County

Peter M. Stone (714) 668-6202
peterstone@paulhastings.com

In San Diego

Christopher H. McGrath (858) 720-2626
christophermcgrath@paulhastings.com

William F. Sullivan (858) 720-2525
williamsullivan@paulhastings.com

In San Francisco

Grace Carter (415) 856-7015
gracecarter@paulhastings.com

John A. Reding (415) 856-7004
johnreding@paulhastings.com

In Stamford

Douglas C. Conroy (203) 961-7411
douglasconroy@paulhastings.com

In Washington D.C.

Lawrence Barcella(202) 508-9525
lawrencebarcella@paulhastings.com

Kirby D. Behre (202) 508-9544
kirbybehre@paulhastings.com

James D. Wareham(202) 508-9511
jameswareham@paulhastings.com

Notes

1) Plaintiffs' Second Amended Complaint was dismissed with prejudice by the district court on November 2, 2001.
2) "Transaction causation" is a separate and independent element of securities fraud claims. It requires a plaintiff to establish that it relied upon the defendant's misrepresentations when making the decision to invest.