

## ***BROUDO V. DURA PHARMACEUTICALS:* HIGH COURT WADES INTO MURKY WATERS OF SECURITIES FRAUD LITIGATION**

by

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Securities fraud litigation is a growth business. On average, private securities class actions are filed against 200 companies every year. The federal government continues to increase its scrutiny of companies, with private litigation often following the announcement of a government investigation. Meanwhile, the Sarbanes-Oxley Act of 2002 lengthened the limitations period for securities fraud claims, thus increasing the time the plaintiffs' bar may investigate potential lawsuits or await the outcome of government investigations, and also created a series of new regulations that may be the basis for future suits. In short, the risk of being sued for securities fraud has never been higher.

In this environment, it is not surprising that the U.S. Supreme Court's recent grant of certiorari in *Broudo v. Dura Pharmaceuticals, Inc.* has generated excitement in the securities litigation defense bar. The issue in *Broudo* is what a plaintiff must allege to adequately plead loss causation. If a securities class action is not dismissed, it is usually settled, largely because of the enormous costs and risks of bringing these cases to trial. Therefore, the motion to dismiss is often the key moment in a case, heightening the importance of the pleading standards. The *Broudo* case marks the first time the Supreme Court has agreed to consider securities fraud pleading standards. The Supreme Court's decision to resolve the present circuit split over loss causation may have dramatic consequences for cases involving issues of intervening causation or where corrective disclosures do not move the market or cannot be linked to the substance of the alleged misrepresentations. As a policy matter, resolving the issue is important because a strong loss causation standard will help prevent the filing of speculative securities class actions that often benefit no one other than the lawyers who litigate the cases.

***Loss Causation and Rule 10b-5 Claims.*** Loss causation – the central issue in *Broudo* – is simply the requirement that the plaintiff demonstrate that the alleged securities fraud caused him to actually suffer an economic loss. Most federal securities fraud actions are brought under Rule 10b-5 (a rule promulgated by the Securities and Exchange Commission (SEC) pursuant to section 10(b) of the Securities Exchange Act of 1934). Rule 10b-5 prohibits, among other things, the making of misleading statements or omissions of material fact in connection with the purchase or sale of any security. In a Rule 10b-5 complaint, the plaintiff must allege specific facts showing that “the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that plaintiff’s reliance on defendant’s action caused injury to the plaintiff.” *Lawrence v. Cohn*, 325 F.3d 141, 147 (2d Cir. 2003) (emphasis added) (internal quotations and citations omitted).

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Courts have broken the causation requirement into two separate elements: transaction causation and loss causation. Transaction causation requires proof that the alleged misconduct induced the plaintiff to engage in the transaction in question. It is equivalent to the actual or “but for” causation in tort law and closely related to the separate Rule 10b-5 requirement of reliance. Loss causation is established by proof that the alleged misconduct caused the plaintiff’s economic loss.<sup>1</sup>

**Why Now?** Although loss causation had not been a heavily litigated issue, it has recently moved to the foreground. The extraordinary rise and crash of the stock market over the past few years, coupled with the subsequent disclosure of allegedly fraudulent practices by Wall Street investment banks, has led to a flurry of lawsuits alleging novel theories of fraud. Courts have grappled with an essential question: did the investment banks cause the identified losses or were they the result of market forces? Beginning with a decision a year ago in *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003) dismissing several securities fraud complaints based on allegedly biased research reports on loss causation grounds – now on an appeal before the Second Circuit – a host of courts have reexamined the meaning of loss causation and, critically, the role it plays at the pleading stage. No fewer than three circuit courts of appeal – including the Ninth Circuit in *Broudo* – have issued opinions reaffirming or clarifying their requirements for pleading loss causation, in the process bringing a circuit split into sharp relief.

**The Purchase Price Disparity Approach.** Two primary approaches to analyzing loss causation have emerged. The first is the purchase price disparity approach, adopted in both the Eighth and Ninth Circuits.<sup>2</sup> Under this approach, the court focuses on the moment the plaintiff purchased his security. If the plaintiff can show that the stock price was inflated at that time due to the defendants’ misconduct, he has established loss causation. The plaintiff need not allege a subsequent decline in the price of his stock due to a corrective disclosure or otherwise. As the Ninth Circuit explained in *Broudo*, 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. 339 F.3d at 938 (citations omitted). In short, if the plaintiff alleges a purchase price disparity, the loss causation requirement is satisfied. *Id.*

To adequately allege that the price was inflated as of the date of purchase, the plaintiff may simply rely on the fraud-on-the-market doctrine. *Id.* The fraud-on-the-market doctrine – adopted by the Supreme Court in *Basic, Inc., v. Levinson*, 485 U.S. 224 (1988) – is normally associated with the reliance element of a securities fraud claim. It eliminates the need for the plaintiff to allege or prove that he relied on, or was even aware of, an alleged misstatement. Rather, “reliance on the statement is rebuttably presumed if the plaintiffs can show that (1) the defendant made public material misrepresentations, (2) the defendant’s shares were traded in an efficient market, and (3) the plaintiffs traded shares between the time the misrepresentations were made and the time the truth was revealed.” *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657, 661 (5<sup>th</sup> Cir. 2004) (citation omitted). Put somewhat differently, the fraud-on-the-market doctrine allows the plaintiff to rely on the market price of the security, which incorporates and reflects the statement at issue. Over the years, courts have held that transaction causation is also satisfied through the fraud-on-the-market doctrine (i.e., the market price incorporates the statements and investors both rely on the integrity of that price and are induced to purchase the security based on that price).

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<sup>1</sup>Although the courts originally developed the loss causation requirement, Congress codified it when it enacted the Private Securities Litigation Reform Act in 1995. See 15 U.S.C. § 78u-4 (b)(4) (“In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.”).

<sup>2</sup>See, e.g., *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824 (8<sup>th</sup> Cir. 2003); *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616 (8<sup>th</sup> Cir. 1991); *Broudo v. Dura Pharms., Inc.*, 339 F.3d at 933 (9<sup>th</sup> Cir. 2003); *Knapp v. Ernst & Whitney*, 90 F.3d 1431 (9<sup>th</sup> Cir. 1996).

Courts applying the purchase price disparity approach have taken the fraud-on-the-market analysis one step further. Because the loss occurs at the time of the purchase, if the plaintiff can show that the stock price was inflated at that time and that he was induced to purchase by the inflated price, he has shown loss causation.<sup>3</sup> In jurisdictions following the purchase price disparity approach, plaintiffs are able to plead loss causation without much difficulty, and courts normally will deny motions to dismiss based on that issue.

***The Price Decline Approach.*** The second approach to loss causation, followed by the Second, Third, Seventh, and Eleventh Circuits, is the price decline approach.<sup>4</sup> Under the price decline approach, not only must the plaintiff show that the defendants fraudulently inflated the stock price at the time of his purchase, he must also show that he lost some or all of his overpayment, usually by alleging a corrective price decline after revelation of the fraud. Accordingly, courts following this approach have rejected the notion that plaintiffs may rely on the fraud-on-the-market doctrine to plead loss causation. As one district court has stated “allowing plaintiffs in a fraud on the market case to satisfy loss causation simply by alleging that a misrepresentation caused the price to be artificially inflated without having to allege any link between the conduct and a decline in price would undoubtedly lead to speculative claims and procedural intractability.” *Merrill Lynch*, 273 F. Supp. 2d at 366 n.28. Instead, these courts require the plaintiff to show that the price of the security declined after the plaintiff’s purchase, and that the alleged fraud was a substantial factor in causing this decline. To satisfy this requirement, the plaintiff typically must show that there was a corrective disclosure followed by a drop in the price of the security.<sup>5</sup>

The rationale for the price decline approach is that a purchase price disparity, by itself, is not a compensable injury. Unless the price of the security declines as a result of exposure of the alleged fraud, the plaintiff has not been damaged. As the Third Circuit explained in *Semerenko v. Cendant Corp.*, “[W]here the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation. In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.” 223 F.3d 165, 185 (3d Cir. 2000) (citation omitted). Thus, under the price decline approach, loss causation is a necessary corollary to the fraud-on-the-market doctrine. While the latter allows the plaintiff to assume that optimistic statements have driven a security price higher, the former requires him to show how the falsity of those statements caused the security price to decline.

The impact of the price decline approach depends heavily on the fact pattern presented to the court. On the one hand, many securities fraud claims follow a simple course of events that allows for a direct link between the alleged fraud and a stock price decline. For example, a securities fraud claim based on a financial restatement that lowers previously announced earnings and results in a stock price decline would appear to present few loss causation pleading issues. On the other hand, many recent securities fraud cases present more difficult scenarios. For example, cases involving significant intervening causes (*e.g.*, the stock

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<sup>3</sup>Based on this line of reasoning, other courts have concluded that the purchase price disparity approach improperly conflates transaction causation and loss causation. *See, e.g., Merrill Lynch*, 273 F. Supp. 2d at 365.

<sup>4</sup>*See, e.g., Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003); *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000); *Bastian v. Petren Res. Corp.*, 892 F.2d 680 (7<sup>th</sup> Cir. 1990); *Roots P’ship v. Lands’ End, Inc.*, 965 F.2d 1411 (7<sup>th</sup> Cir. 1992); *Robbins v. Kroger Properties, Inc.*, 116 F.3d 1441 (11<sup>th</sup> Cir. 1997). Based on unreported decisions, it appears that the Sixth Circuit may also have joined the majority approach camp. *See, e.g., Campbell v. Shearson/American Exp., Inc.*, Nos. 85-1703, 85-1714, 1987 WL 44742 1 at \*2 (6<sup>th</sup> Cir. Sept. 9, 1987) (“If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule [10b-5] is not permitted.”).

<sup>5</sup>In rare instances, an actual price decline may not be necessary. For example, a company could release unrelated positive information along with the corrective disclosure so that the stock price does not decline. Nonetheless, there may still be a loss sufficient to bring a claim because the “stock does not appreciate as it would have absent the fraudulent conduct.” *Gebhardt*, 335 F.3d at 831-32.

market crash) or where the corrective disclosure does not move the market or cannot be linked to the substance of the alleged misrepresentations may warrant additional scrutiny for loss causation. Courts are responding and appear willing to closely examine the complaint, and, in some cases, grant dismissals. *See, e.g., D.E. & J. Ltd. P'ship v. Conaway*, 284 F. Supp. 2d 719, 749 & n.25 (E.D. Mich. 2003) (no loss causation where bankruptcy filing did not reveal inaccuracies in financial statements or audit opinions)

***Impact of the Competing Approaches and the Broudo Decision.*** The differences between the two approaches have significant consequences. Under the price decline approach, loss causation will, in some cases, present an opportunity for defendants to successfully dismiss a complaint or prevail on summary judgment. Under the purchase price disparity approach, loss causation is relatively straightforward to plead and involves a largely factual inquiry that is very difficult to resolve short of trial.

*Broudo* itself demonstrates the impact of these diverging approaches. In that case, the plaintiff alleged that the defendants made misleading statements about clinical trials needed for FDA approval of Dura's Albuterol Spiros asthma medication delivery device. On February 24, 1998, Dura revealed that it expected lower-than-forecast 1998 revenues and 1998 earnings per share, but did not make any disclosures about its Albuterol Spiros delivery system. The February 24 announcement caused Dura's stock price to decline by 47%. 339 F.3d at 936. It was not until November 1998, nearly nine months after the end of the class period, that Dura announced the FDA had "found the Albuterol Spiros device not approvable due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns." *Id.* The district court found that the plaintiffs had failed to properly plead loss causation for his claims based on misleading statements concerning the Albuterol Spiros device because the complaint did "not contain any allegations that the FDA's non-approval [of the Albuterol Spiros device] had any relationship to the February price drop." *Id.* at 937. Thus, the district court, by applying the price decline approach, concluded the plaintiff had not adequately alleged loss causation and dismissed the case.

The Ninth Circuit reversed. It held that the plaintiffs did not need to allege "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." *Id.* at 938 (citation omitted). In a "fraud on the market case," loss causation "merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause." *Id.* The court reasoned that the plaintiff's injury happens when the stock is purchased at an inflated price. *Id.* What happens to the stock price later is simply irrelevant. By applying the purchase price disparity approach instead of the price decline approach, the Ninth Circuit reached a completely different conclusion and the case was allowed to proceed.

***Looking Ahead to the Supreme Court.*** The *Broudo* case presents the Supreme Court with the opportunity to resolve a growing rift on an important issue in securities fraud cases. Although many commentators have learned the hard way that it is difficult to predict how the Supreme Court will rule in a given case, the facts and history here appear to indicate that the Court will be inclined towards the price decline approach. Not only has the Supreme Court shown a propensity in recent years to reverse the Ninth Circuit, but (more substantively) a majority of the circuit courts that have addressed the question have followed the price decline approach. Moreover, the Supreme Court typically accords positions taken by the Department of Justice and the SEC a great deal of deference, and both have already indicated their belief that the Ninth Circuit erred. While the cert petition was pending, the Department of Justice and the SEC submitted an *amicus* brief siding with the request for review, arguing that the price decline approach is the appropriate standard rule for alleging loss causation. They can be expected to make the same arguments on the merits. Finally, the extreme nature of the facts in the case – a decline that preceded the "truth revealed" by nine months – will weigh in favor of the price decline approach.

Given the infrequency with which the Supreme Court reviews securities litigation issues, the Court's decision to hear *Broudo* itself merits attention. Whether the Supreme Court will go any further than the direct issue of loss causation (e.g., a broader discussion of pleading in securities fraud cases) remains to be seen. Whatever the ultimate result, the ruling will send important signals both to lower courts and the securities bar as to the rigor with which plaintiffs must plead their cases. Companies and their counsel are rooting for a clear victory at a time when they could use all the help they can get.