The pattern is familiar. A public company makes some positive announcements about a product. After some time passes, the company announces bad news about the product, leading to a decline in the stock price. A shareholder then sues, alleging that the company's positive statements misled investors who were damaged by the amount of the stock drop. This simple model describes many shareholder actions under the federal securities laws. But what if the drop in the stock price is not related to the prior positive statements? May shareholders still pursue a securities fraud claim alleging that they were damaged?

In *Dura Pharmaceuticals v. Broudo*, the Supreme Court answered that question with a unanimous “no.” *Dura Pharmaceuticals v. Broudo*, No. 03-932,2005 WL 885109 (U.S.Apr.19, 2005). The Supreme Court reversed a decision by the Ninth Circuit Court of Appeals that permitted a shareholder to state a claim based solely on allegations that the price of a security was inflated at the time of the purchase, even where the alleged misrepresentation was not related to any meaningful drop in the stock price. The Supreme Court required, instead, that a plaintiff in a securities fraud lawsuit plead and prove a causal connection between a company's alleged misrepresentations and a subsequent loss in stock value. Typically this will require the plaintiff to plead and prove that the stock price dropped because the true facts related to the alleged misrepresentation were revealed.

The Supreme Court's decision should help rein in some of the more expansive and abusive cases brought by shareholders under the federal securities laws. It will now be difficult for plaintiffs to base a claim on a statement for which there is no related corrective disclosure and price drop. And even where there is such a disclosure and price drop, the decision provides support for defendants arguing that the price drop was caused by other factors. As a result, defendants will have new grounds to challenge claims and to limit the scope of cases.

**Supreme Court Distinguishes Transaction Causation and Loss Causation**

To prevail in a private action under Section10(b) of the Securities Exchange Act of 1934 and Rule10b-5 under the Exchange Act, a plaintiff must prove two different types of causation.

- **Transaction Causation.** The first, usually referred to as "transaction causation" or "but-for causation," requires proof that the plaintiff relied on a misrepresentation and would not otherwise have bought the securities. In a typical shareholder class action, the fraud-on-the-market theory satisfies this element, allowing a rebuttable presumption that the market price of a publicly traded security reflects the effects of any material misrepresentation.

- **Loss Causation.** The second causation element, commonly known as "loss causation," requires proof of a causal connection between the allegedly material misrepresentation and the plaintiff's economic loss. Most courts have equated "loss causation" with the common-law concept of proximate cause. The Private Securities Litigation Reform Act of 1995, an act of Congress designed to deter frivolous and abusive securities litigation, highlighted the importance of loss causation by explicitly including it as a statutory requirement for Section10(b) and Rule10b-5 claims. 15U.S.C. §78u-4(b)(4).

*Dura Pharmaceuticals* dealt only with loss causation. The plaintiffs in *Dura* alleged, among other things, that the company's stock price was inflated when they purchased it because the company had made misstatements about the FDA's future approval of a new asthmatic spray device produced by the company. The plaintiffs did not allege how the misstatements about the FDA approval of the spray device caused their stock losses. Indeed, the complaint alleged that most of the drop in the company's stock price occurred before the market learned that the FDA would not approve the company's new device, and that this subsequent disclosure resulted in only a temporary drop in the company's stock price that almost fully recovered within one week. The District Court dismissed the complaint holding that with respect to the spray device claim, plaintiffs failed to adequately allege loss causation. The Ninth Circuit reversed, reasoning that the allegation of price inflation was sufficient.

**The Split Among the Circuits**

Federal appellate courts had disagreed over what is needed to allege and prove loss causation. Most appellate courts have required a plaintiff to tie shareholder losses to a disclosure that revised or corrected prior public statements and was followed by a drop in the stock price. *E.g.*, *Lentell v. Merrill Lynch& Co.*, 396 F.3d 161, 173 (2d Cir. 2005); *Semerenko v. Cendant Corp.*, 223 F.3d...
Decision Should Help Protect Defendants From Inherently Speculative Damage Claims

The Supreme Court's Analysis

The Supreme Court's unanimous decision reversed the Ninth Circuit on several independent but related grounds. Central to the decision was the need to establish proximate causation in order to prove loss causation. Starting from this basic premise, the Court held that, in a fraud-on-the-market case, an inflated purchase price by itself does not constitute or proximately cause economic loss. 2005 WL 885109, at *4.

- **Logic Dictates That Alleged Artificial Inflation by Itself Does Not Cause a Loss.** In rejecting the Ninth Circuit's rationale that "injury occurs at the time of the transaction," the Supreme Court found, as a matter of simple logic, that a plaintiff suffers no loss at the moment that he or she purchases a security, as "the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value." Id. Nor is there invariably a strong link between the inflated purchase price and a later economic loss. For example, shareholders who sell their securities before the truth emerges will not suffer a loss; presumably, the same inflation is in the price of the security at the time of sale as at the time of purchase. Even if the shareholder sells after the truth emerges, an initially inflated price does not inevitably mean a later loss. This is true, the Court indicated, even if the sale price was lower than the purchase price, as the lower price could reflect numerous considerations other than the alleged misrepresentation, including "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price." 2005 WL 885109, at *4.

- **Common-Law Antecedents Require Proof of Proximate Causation.** The Supreme Court found additional support for its decision in the common-law roots of securities fraud actions: "the common law has long insisted that a plaintiff in such a case show not only that he had known the truth he would not have acted but also that he suffered actual economic loss." These common-law roots, the Court observed, have led most courts of appeal to reject the Ninth Circuit's approach of proving loss causation based on an inflated purchase price in favor of a proximate cause analysis. 2005 WL 885109, at *5.

- **Proof of Proximate Causation Is Consistent With Objectives of Federal Securities Laws.** Finally, the Supreme Court cited the narrow objective of the securities laws to maintain public confidence in the marketplace. The federal securities laws, including the Private Securities Litigation Reform Act of 1995, are designed "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." The Court noted that the Private Securities Litigation Reform Act of 1995 "expressly imposes on plaintiffs 'the burden of proving' that the defendant's misrepresentations 'caused the loss for which the plaintiff seeks to recover.'" The Court added:

  > The [Act] thereby makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss. By way of contrast, the Ninth Circuit's approach would allow recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss.

The Supreme Court concluded that the Ninth Circuit's approach was "inconsistent with the law's requirement that a plaintiff prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss." 2005 WL 885109, at *6.

Supreme Court Applied Analysis to Securities Claim Pleading Standards

Based on its determination of what plaintiffs must prove to establish loss causation, the Court held that a complaint is defective if it merely alleges that the plaintiff paid an artificially inflated price for the securities in question and therefore suffered damages. Rather, the complaint must give defendants "notice of what the relevant economic loss might be or of what the causal connection might be between that loss and the [alleged] misrepresentation...." The Court feared that to "allow[ing] a plaintiff to forgo giving any indication of the economic loss and proximate cause ... 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," and thereby impermissibly transform a securities action into a "partial downside insurance policy." 2005 WL 885109, at *7.

Decision Should Help Protect Defendants From Inherently Speculative Damage Claims
With the *Dura Pharmaceuticals* decision the Supreme Court has reined in an overly broad extension of the federal securities laws, helping to protect companies, officers and directors from damage claims that are inherently speculative. In many securities fraud cases the alleged misrepresentations can arguably be tied to a drop in the stock price – typically through a disclosure of what plaintiffs call the “true facts.” Companies and other defendants will still face damages claims in those cases. But where misrepresentations cannot be tied to a price drop, or where the price drop can be attributed at least in part to factors other than the alleged misrepresentations, the decision should provide additional protection from claims.

The decision leaves a number of issues for the lower courts to decide. But, especially in the Ninth Circuit, this decision provides practical and important new tools for companies, officers and directors defending themselves in a securities case. For example:

- It provides an additional basis upon which to seek dismissal for failure to plead an essential element of the securities fraud claim;

- It provides a strong argument against securities fraud claims by individual plaintiffs who sold their stock before the market received a corrective disclosure of the alleged misrepresentation or omission;

- If a complaint survives a motion to dismiss, it strengthens defense arguments that any class should exclude those who sold their securities during the class period; and

- Regardless of how the class is defined, it provides additional support for the argument that claimed damages should be reduced by in-and-out-traders and as a result of the evidence that factors other than the alleged misrepresentation caused or contributed to the drop in price of the stock.

**Additional Information**

This Update summarizes the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*. You can find discussion of other recent cases and other topics of interest on our website.

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