DIRECTORS' AND OFFICERS' LIABILITY

WHAT'S AT STAKE IN DURA

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OCTOBER 14, 2004

The Supreme Court's return this Term to private securities litigation -- and its first consideration of the Private Securities Litigation Reform Act -- promises to bring needed clarity to the doctrine of loss causation. The proper standard for loss causation has been in court-acknowledged conflict for at least seven years. In Dura Pharm., Inc. v. Broudo,[1] the Supreme Court will consider whether a private securities fraud plaintiff invoking the fraud-on-the-market presumption of reliance must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price. The Ninth Circuit said no; plaintiffs sufficiently plead loss causation if they allege that the price of the stock on the date of purchase was inflated by a misrepresentation. With argument likely to be scheduled early next year, it is worthwhile to examine the issues presented by Dura, and what is at stake.

Lower Court Proceedings

Plaintiffs alleged securities fraud claims against Dura and certain officers and directors on behalf of a purported class of persons who purchased Dura stock between April 15, 1997 and February 24, 1998. The purchases allegedly were at prices inflated by material misrepresentations and omissions made by defendants during the class period concerning (i) sales of Dura's Ceclor CD antibiotic, and (ii) the prospects of a new drug-delivery product called Albuterol Spiros, for which Dura was seeking FDA approval. On February 24, 1998, Dura announced that its quarterly and annual results would fall below analysts' expectations, due in part to slower-than-expected sales of Ceclor CD and another product line and because of Dura's need to expand its sales force. The February 24 announcement did not mention Albuterol Spiros. The Company's share price declined 47% in one day. The "loss" for which plaintiffs sought recovery related exclusively to the 47% price decline that occurred between February 24 and 25, 1998.

FDA Approval

The Dura loss causation dispute is confined to the allegations concerning the Albuterol Spiros device. Plaintiffs alleged that defendants' statements during the class period that Dura had completed its Phase III trials and would be seeking FDA approval of Albuterol Spiros were misleading because defendants failed to disclose that the device suffered from "electro-mechanical" defects, and that Dura had made changes to the device during clinical testing, which would prevent FDA approval. On November 3, 1998 (nearly nine months after the close of the proposed class period), Dura announced that the FDA did not approve the application for Albuterol Spiros, citing issues of electro-mechanical reliability and the need for additional clinical trials. Plaintiff elected, however, to close their proposed class period on February 24, 1998, upon the 47% price decline and not nine months later, when Dura experienced a temporary 21% price decline upon announcement of the FDA disapproval. Plaintiffs' pleading choice presumably was driven by the fact that Dura's share price quickly rebounded from the latter dip.

The district court dismissed all claims concerning Albuterol Spiros, holding that plaintiffs failed to plead loss causation because the complaint did not allege that the FDA's non-approval of the device had any relationship to the February price drop. The Ninth Circuit reversed, faulting the district court for, *inter alia*, assuming that "that the loss causation element requires a demonstration of a corrective disclosure followed by a stock price drop during the class period and that those facts must be alleged in the complaint."[2] Rather, the Ninth Circuit held that "in a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the 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, because the injury occurs at the time of the transaction." The court acknowledged that "other circuits are less favorable to plaintiffs and do require demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint." The Ninth Circuit's ruling conflicts with, among other decisions, the Third Circuit's decision in *Semerenko v. Cendant Corp.*, which held "that an investor must also establish that the alleged misrepresentations proximately caused the decline in the security's value to satisfy the element of loss causation."[3]

The Appeal

The thrust of the appeal is that, contrary to the PSLRA and case law, the Ninth Circuit's purchase price inflation approach collapses loss causation into transaction causation, and may enable plaintiffs in a fraud-on-the-market case to recover damages even if the actual investment losses sustained are not caused by any wrongdoing of the defendants. Courts have viewed transaction causation and loss causation as two necessary and independent components to causation in securities fraud claims for at least three decades.[4] Transaction causation ordinarily is equated with reliance -- it focuses on purchase-time events and requires allegations and proof that the alleged wrongdoing caused plaintiffs to make the investment in which they lost money. Loss causation is the securities law equivalent of the tort principle of proximate cause – plaintiffs to must allege and prove that the defendant's wrongdoing actually caused their economic loss. The justification for the loss causation requirement is that a person induced to invest by a misrepresentation should not be permitted to recover for a decline in value unrelated to the misrepresentation. By insisting on an identifiable causal connection between a defendant's alleged misconduct and a plaintiff's losses, loss causation allows courts to consider intervening factors, such as broader market conditions, which may have caused the price decline, in deciding whether and to what extent to a defendant may be liable for securities fraud.

In adopting the PSLRA, Congress heightened and supplemented the standards for pleading securities fraud claims by, among other things, codifying the judge-made "loss causation" requirement as an element of such claims. Congress sought to ensure "that plaintiffs prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors."[5] Accordingly, the PSLRA prescribes that a plaintiff who brings a securities fraud claim "shall have the burden of proving that the act or omission of the defendant alleged to violate [the Exchange Act] caused the loss for which the plaintiff seeks to recover damages."[6]

Defendants in Dura will urge the Supreme Court that the Ninth Circuit's price inflation theory is inconsistent with the language and intent of the PSLRA to mandate allegations, and proof, of a direct causal link between the falsity of an alleged misrepresentation and the loss. Applying a price inflation theory – which focuses on value at the time of the purchase – disrupts the PSLRA's overall statutory approach to loss causation. First, the Ninth Circuit's theory would render the PSLRA's "look back" damages provision superfluous. In order to bolster its limitation on damages to those losses caused by defendants' conduct and not extraneous factors, Congress enacted a 90-day "look back" period intended to limit potentially available damages where a stock does not decline after a corrective disclosure, or declines but then recovers. Section 21D(e)(1) of the PSLRA limits damage claims for investors who held shares for at least 90 days after a corrective disclosure to the difference between their purchase price and the average trading price during the 90 days following dissemination of a corrective disclosure. Because the PSLRA examines the price of the security to measure an investor's damages "beginning" with the date "information correcting the misstatement or omission" is disseminated, defendants will argue, the only coherent interpretation of loss causation is one that requires a causal connection between the alleged fraud and price decline. If the Ninth Circuit is correct that an investor can establish loss causation simply by alleging price inflation at the time of purchase, Section 21D(e)(1)'s mandate that any 90-day market reaction following a corrective disclosure dictate the damages available to the plaintiff seems pointless.

Second, a causal connection between the fraud and any loss is needed to ensure treatment of 10b-5 loss causation consistent with Section 12 of the Securities Act of 1933, which creates a private right of action for material misstatements or omissions made in connection with an offer or sale of a security by means of a prospectus or oral communication. Section 105 of the PSLRA amended Section 12 to provide defendants with an affirmative defense of loss causation. A Section 12 defendant may prove that "any portion or all of the amount recoverable . . . represents other than the depreciation in value of the subject security resulting from" defendant's false or misleading statements. Any portion of damages not traceable to defendant's statement "shall not be recoverable."[7] Congress defined a Section 12 recoverable loss as "the depreciation in value" attributable to defendant's conduct, defendants will urge, as part of an overall effort to interpose loss causation as a screening device that separates any portions of a security's post-transaction decline that are traceable to the fraud from those that are not. In Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,[8] the Supreme Court said it would be "anomalous to impute to Congress an intention in effect to expand [the contours of] 10b-5 actions beyond the bounds delineated for comparable express causes of action." This objective of consistency and coherence in the securities laws should weigh heavily on the appeal's disposition.

Fraud on the Market

The issue presented also will likely require the Supreme Court to revisit the fraud-on-the market presumption of reliance. In Basic v. Levinson,[9] a plurality of the Supreme Court held that 10b-5 plaintiffs who purchase shares traded in an efficient market need not prove direct reliance on a defendant's misrepresentation; rather, they may use a rebuttable presumption of reliance on defendant's alleged material misrepresentation. The efficient market theory presumes that a well-developed, efficient market will incorporate all publicly available, material information into the security's price. In Dura, defendants will argue that the Ninth Circuit's holding improperly extends the presumption under the fraud-on-the-market theory of reliance to the distinct element of loss causation.

In a fraud-on-the market case, if a material misrepresentation inflates a stock's price, the inflation caused by the misrepresentation will remain incorporated in the stock's value until the true facts are revealed (usually in a corrective disclosure) and absorbed by the efficient market. If the inflation carries over until a corrective disclosure reveals the truth, an investor who purchases a stock at a price inflated by defendant's alleged misrepresentation sustains no economic loss unless and until the market reacts to the disclosure of the truth. This is why, as the Second Circuit recently held, "a purchase-time value disparity, standing alone, cannot satisfy the loss causation pleading requirement."[10]

A corollary to this argument is that Dura risks awarding windfall damages to "in-and-out traders," who purchase stock at an artificially inflated price, but also sell at an artificially inflated price. In the absence of a corrective disclosure, the artificial inflation allegedly caused by defendants' wrongdoing remains embedded in the stock price at the time of the in-and-out trader's sale. As the Third Circuit has noted, "[i]n 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."[11] In other words, if a corrective disclosure has not been made, shareholders who still hold the stock can recover any artificial inflation that they initially overpaid simply by reselling the stock. Shareholders who bought and sold during a class period have thus already recouped the artificial inflation. Absent a corrective disclosure, the efficient market theory compels the conclusion that any decline in the stock price between the purchase and sale by an in-and-out trader must have been caused by something other than the purported fraud. If the stock declines for reasons unrelated to the alleged fraud, these shareholders sustained no securities fraud damages -- they have not suffered any investment loss caused by a misrepresentation.

Conclusion

The Supreme Court's Dura decision is likely to affect the class of persons who can recover securities fraud damages and how a plaintiff may prove that its losses were caused by a misrepresentation. There is little to recommend the proposition that merely alleging or even proving inflation at the time of plaintiff's purchase also establishes that defendant's wrongdoing also caused plaintiff's loss. If a plaintiff cannot connect a decline in a company's stock price to any alleged fraud, the PSLRA forecloses recovery. The purpose of a loss causation requirement is to prevent investors from using the securities laws to recoup losses sustained through factors unrelated to any misrepresentation or fraud. If there is no requirement that plaintiffs plead a causal connection between defendants' alleged wrongdoing and their loss, courts will have little ability to dismiss securities claims on the basis of losses attributable to intervening causes ranging from market or industry wide factors, to intrinsic stock price volatility. By requiring that a shareholder allege only that the market price was inflated at the time of purchase, the Ninth Circuit's loss causation standard also would permit certain shareholders to recover the artificial inflation in the purchase price by selling the stock pre-correction at a still-inflated price, and then "double-dip" by recovering damages in a securities class action.

1 339 F.3d 933 (9th Cir. 2003), cert. granted, 124 S. Ct. 2904 (2004).

2 Id. at 938 (9th Cir. 2003).

3 223 F.3d 165, 185 (3d Cir. 2000).

4 Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974).

5 S. Rep. No. 104-98, at 7 (1995).

6 15 U.S.C. § 78u-4(b)(4).

7 15 U.S.C. § 771(a).

8 511 U.S. 164, 180 (1994).

9 485 U.S. 224 (1988).

10 Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 198 (2d Cir. 2003).

11 Semerenko, 223 F.3d at 185.