FRIEDMAN KAPLAN SEILER & ADELMAN LLP

How Broad Are the Implications of the Supreme Court's Ruling on Loss Causation in *Dura Pharmaceuticals*?

On April 19, 2005, the United States Supreme Court ruled unanimously in *Dura Pharmaceuticals, Inc. v. Broudo*[1] that in order to satisfy the necessary element of "loss causation," a plaintiff in a securities fraud action must allege and prove more than that the price of the security on the date of purchase was inflated because of a misrepresentation. Rather, the plaintiff must plead and prove that the price of the security later declined when the truth became known, such that the defendant's fraud (rather than other factors) caused the loss.

The decision did not purport to announce a new rule or break new legal ground, and is consistent with longstanding authority in the Second Circuit and other U.S. Courts of Appeals. The impact of *Dura* will probably be limited to securities fraud cases involving publicly traded securities (typically class actions), and will not likely extend to actions involving privately negotiated transactions or common law fraud, where its application arguably would be inconsistent with established state law.

The *Dura* Decision

In *Dura*, the Supreme Court resolved a split among U.S. Courts of Appeals regarding what a plaintiff in a private securities fraud action must plead and prove to satisfy the element of "loss causation" – the requirement that a plaintiff prove that the defendant's misrepresentation "caused the loss for which the plaintiff seeks to recover."[2]

The Ninth Circuit had held that a plaintiff could plead loss causation merely by alleging that the price of the security was inflated on the date of purchase because of the defendant's misrepresentation.[3] That court reasoned that "the injury occurs at the time of the transaction" through payment of an excessive price.[4]

The Supreme Court disagreed, holding that it is not enough that the price of the stock was inflated at the time of purchase; the plaintiff has to allege and prove that she subsequently suffered an economic loss caused by the subject of the misrepresentation.[5] The Court observed that "[n]ormally, in cases such as this one (*i.e.*, fraud-on-the-market cases), an inflated purchase price will not itself constitute or proximately cause the relevant economic loss."[6] The Court explained that a purchaser who buys publicly traded securities at an inflated price receives a security worth exactly what she paid at the time of the purchase: "[T]he inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value."[7] The plaintiff thus incurs no economic loss at the time of purchase.

If the plaintiff sells later, after the truth makes its way into the marketplace, the correction of the misrepresentation *might* be the cause of a subsequent decline in value. However, the Supreme Court observed that a "tangle of factors" could also account for some or all of the price decline, such as "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events."[8] In light of the possibility that any or all of these other factors could account for the lower price, the Court emphasized the importance of requiring that the plaintiff plead, and ultimately prove at trial, that the economic loss incurred

was proximately caused by the defendant's misrepresentation or omission.

How Broadly Will *Dura* Be Applied?

The reasoning of the *Dura* decision suggests that its holding may be limited to securities fraud cases involving publicly traded securities which, like *Dura* itself, are typically brought as class actions. In these cases, the loss is not incurred at the time of purchase because the price of the security is set by the market, not by the intrinsic value of the underlying company. In contrast, a purchaser of a security whose price was privately negotiated may incur an actionable loss at the time of purchase if, as a result of a misrepresentation or omission, the security the purchaser receives is worth less than the price paid and there is neither a publicly articulated value nor a readily available buyer. Indeed, the Court in *Dura* emphasized a buyer's ability to immediately resell the security at an equivalent price in the marketplace as an indication that no loss occurred upon purchase. That logic does not apply in the case of a private securities transaction.

The Supreme Court also cited the common law of deceit and misrepresentation in reaching its conclusion that a plaintiff alleging a federal securities fraud claim does not incur a loss at the time of purchase even if the stock's value was allegedly inflated by fraud.[9] In doing so, *Dura* may invite further litigation, as the Court's holding is arguably inconsistent with the method for calculating fraud damages under the common law of various states. Under the law of New York and California, for example, damages for fraud are generally measured using the "out-of-pocket" rule, by which the plaintiff may recover the difference between the amount paid and the value of the property received. Usually, out-of-pocket damages are calculated as of the time of the transaction.[10] Thus, the Supreme Court's reliance on the common law to support its conclusion that loss cannot be established at the time of purchase may be subject to question.

Plaintiffs will argue that *Dura*'s apparent inconsistency with the state law practice of measuring damages at the time of the transaction supports the view that the opinion is limited to cases involving publicly traded securities. Defendants, on the other hand, may use the opinion to urge state courts to reexamine the elements of loss causation under the common law.

Pleading and Proving Loss Causation

Dura raises a number of practical questions for litigants in securities fraud cases. First, what must a plaintiff plead with respect to loss causation in order to state a claim for securities fraud? The *Dura* opinion makes clear that a plaintiff must allege that the price of the security declined when the truth was disclosed and thus the loss was caused at least in part by the misrepresentation. Defendants will likely move to dismiss as insufficient any securities fraud claim in which the plaintiff does not make such an allegation.

The Supreme Court also appeared to invite further litigation when it assumed "for argument's sake" that the pleading of loss causation is subject to Rule 8 of the Federal Rules of Civil Procedure, which requires only "a short and plain statement of the claim showing that the pleader is entitled to relief."[11] This left the door open for defendants to argue that a plaintiff must plead loss causation with the specificity required by Rule 9(b), which applies to allegations of fraud. Plaintiffs, on the other hand, will argue that a complaint merely needs to provide the defendant "with some indication of the loss and the causal connection" between that loss and the misrepresentation.[12]

1633 BROADWAY
NEW YORK, NY 10019-6708
TEL: (212) 833-1100
FAX: (212) 833-1250
E MAIL: INFO@FKLAW.COM
WWW.FKLAW.COM

After pleading loss causation, what must a plaintiff do to prove it? Increasingly, plaintiffs in securities fraud actions have been required to submit a detailed analysis, usually in the form of an "event study," to demonstrate a causal connection between the losses suffered and the defendant's misrepresentation. An event study is a statistical analysis that examines the effect of an event on a dependent variable, such as a corporation's stock price.[13] The purpose of the event study is to isolate the influence of information specific to the company that the defendant allegedly misrepresented or concealed. A number of district courts have excluded testimony from plaintiffs' experts where the expert did not perform an event study, and then dismissed the securities fraud claim for failure to prove loss causation.[14] In the wake of *Dura*, it is likely that this trend will continue.

Conclusion

Although the Supreme Court's decision in *Dura* is important in resolving a split among the circuits concerning the requirements for pleading and proving loss causation in securities fraud cases, future cases will determine whether its holding is limited to actions involving publicly traded securities where the price of the security is set by the market, or is extended to cases involving private securities transactions or common law fraud.

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If you would like more information about the *Dura* decision, please contact Hal Neier (at 212-833-1111 or hneier@fklaw.com) or Emily Stubbs (at 212-833-1193 or estubbs@fklaw.com).

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[1] No. 03-932, 544 U.S. ___ (Apr. 19, 2005).

[2] *Dura*, slip op. at 8.

[3] *Id.* at 3.

[4] *Id.*

[5] The Supreme Court contrasted the Ninth Circuit's holding with, among other decisions, *Emergent Capital Investment Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003), *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000), and *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997). *Dura*, slip op. at 6. *See also Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005).

[6] *Dura*, slip op. at 5.

[7] *Id.* (emphasis in original).

[8] *Id.* at 5-6.

[9] *Id.* at 6-7.

[10] *See*, *e.g.*, *Lama Holding Co. v. Smith Barney Inc.*, 88 N.Y.2d 413, 421, 646 N.Y.S.2d 76, 80, 668 N.E.2d 1370, 1373-74 (1996); *Reno v. Bull*, 225 N.Y. 546, 553, 124 N.E. 144, 146 (1919); *Alliance Mortgage Co. v. Rothwell*, 10 Cal. 4th 1226, 1240, 44 Cal. Rptr. 2d 352, 900 P.2d 601 (1995); *Salahutdin v. Valley of Cal., Inc.*, 24 Cal. App. 4th 555, 568, 29 Cal. Rptr. 2d 463 (1994).

[11] *Dura*, slip op. at 9.

[12] *Id.* at 10.

[13] *See RMED Int'l, Inc. v. Sloan's Supermarkets, Inc.*, No. 94 Civ. 5587 PKL RLE, 2000 WL 310352, at *6 (S.D.N.Y. Mar. 24, 2000).

[14] *See*, *e.g.*, *In re Zonagen, Inc. Secs. Litig.*, 322 F. Supp. 2d 764, 781-83 (S.D. Tex. 2003); *In re Imperial Credit Indus., Inc. Secs. Litig.*, 252 F. Supp. 2d 1005, 1014-16 (C.D. Cal. 2003); *In re Northern Telecom Ltd. Secs. Litig.*, 116 F. Supp. 2d 446, 460-61 (S.D.N.Y. 2000).

1633 BROADWAY
NEW YORK, NY 10019-6708
TEL: (212) 833-1100
FAX: (212) 833-1250
E MAIL: INFO@FKLAW.COM
WWW.FKLAW.COM