

# **DURA TWO YEARS LATER: THE CONTINUING STRUGGLE TO DEFINE LOSS CAUSATION**

*Thomas O. Gorman  
Porter Wright Morris & Arthur LLP  
[www.SECactions.com](http://www.SECactions.com)  
August 7, 2007*



# INTRODUCTION

- ◆ **Dura Pharmaceuticals, Inc. v. Broude, 544 U.S. 356 (2005) was decided two years ago**
- ◆ **Requires pleading/proof of loss causation beyond price inflation**
- ◆ **Significant impact on private securities fraud suits for damages**

# INTRODUCTION

- ◆ To analyze the impact we will consider:
  1. Origins: Evolution of loss causation in private securities cases
  2. The decision in Dura

# INTRODUCTION

## ◆ Impact of Dura (cont'd)

### 3. Specific applications

- a. Pleading requirements
- b. Fraud on market
- c. Materialization
- d. How much truth must be revealed
- e. Is general bad news sufficient
- f. Who must reveal the truth
- g. Impact of other causes of price drops
- h. Effect of disclosures before/after price drop

### 4. Conclusions

# ORIGINS IN SECURITIES CASES

## ◆ Evolution of loss causation

- Section 10(b) claim—causation is one element

- Elements of claim

1. Material misrepresentation or omission
2. Scier or wrongful state of mind
3. In connection with purchase/sale of security
4. Reliance or transaction causation
5. Economic loss (15 U.S.C. § 78u-4(b)(4))
6. Loss causation

# ORIGINS

## ◆ Evolution of loss causation (cont'd)

### – Defined

1. Transaction causation – reason person invested; sometimes called “but for”
2. Loss causation – links the fraud to the loss of the investor; sometimes called “proximate cause”

# ORIGINS

## ◆ Evolution of loss causation (cont'd)

### – Section 10(b) cause of action

- ◆ Implied by the courts
- ◆ Common law roots

### – Common law fraud requires proof of reliance and causation

# ORIGINS

## ◆ Evolution of loss causation (cont'd)

- Four key securities cases trace the evolution of the causation requirement:

1. List v. Fashion Park, 340 F.2d 457 (2<sup>nd</sup> Cir. 1965)

Based on common law, reliance found to be key link between misrepresentation and injury

2. Globus v. Law Research Service, Inc., 418 F.2d 1276 (2<sup>nd</sup> Cir. 1969)

Required proximate cause between misrepresentation and the injury



# ORIGINS

## ◆ Evolution of loss causation (cont'd)

3. Schlick v. Penn Dixie, 507 F.2d 374 (2<sup>nd</sup> Cir. 1974)

First case to use the phrase loss causation; in a misrepresentation case, court required both transaction and loss causation

4. Huddleston v. Herman & MacLean, 640 F.2d 534 (5<sup>th</sup> Cir 1981)

Causation requirement satisfied “only if the misrepresentation touches upon the reasons for . . .” the loss

# ORIGINS

## ◆ Evolution of loss causation (cont'd)

- The fraud on the market theory
- Basic v. Levinson, 485 U.S. 224 (1988)
  - ◆ Reliance is a key element of a Section 10(b) claim
  - ◆ In a securities market transaction, reliance is based on the integrity of the market
  - ◆ Substitutes for reliance unless presumption is rebutted

# ORIGINS

## ◆ Evolution of loss causation (cont'd)

- PSLRA codifies loss causation requirement

**“In any private action . . . Plaintiff shall have the burden of proving that the act or omission . . . caused the loss . . . .”**

- The statute does not define the terms

# ORIGINS

- ◆ **Evolution of loss causation (cont'd)**
  - **Prior to Dura, the circuits split over loss causation**
    - ◆ **2<sup>nd</sup>, 3<sup>rd</sup> & 11<sup>th</sup> Cir. required more than price inflation to establish link between misrepresentation/omission and injury, e.g., Emergent Capital Inv. v. Stonepath Group, 343 F.3d 189 (2<sup>nd</sup> Cir. 2003)**



# **THE DURA OPINION**

- ◆ **D. Ct. dismissed the complaint holding:**
  - **On a claim of false profitability – plaintiff failed to plead scienter**
  - **On claim of false statements re FDA approval for a device – failed to plead loss causation**
  - **Ninth Circuit reversed: fraud on the market theory permitted presumption that inflated price caused injury**

# THE DURA OPINION

## ◆ Supreme Court reversed

### – Logic

#### ◆ As a matter of logic an inflated price

- Does not mean there is a loss; “an artificially inflated purchase price *might* mean a later loss”
- The longer the time between purchase and sale, the more likely other factors caused loss
- Fact that complaint fails to state share price fell after truth came out suggests plaintiff thought artificial price sufficient

# **THE DURA OPINION**

## **◆ Supreme Court (cont'd)**

### **– PSLRA**

- ◆ An inflated price might “touch” upon loss; but under PSLRA that is not enough
- ◆ Loss causation rule is consistent with key goal of PSLRA of maintaining confidence in markets, but not insuring loss

### **– Common Law**

- ◆ The holding of the 9<sup>th</sup> Circuit lacks precedent
- ◆ Securities fraud has common law roots
  - Basic tort theory requires reliance
  - Most courts require reliance





# **THE DURA OPINION (cont'd)**

## **◆ Supreme Court (cont'd)**

### **– Pleading requirements**

- ◆ Rule 8 pleading only requires short plain statement to give “fair notice”
- ◆ “It should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff had in mind.”

### **– Policy**

- ◆ Absent a loss causation requirement, baseless claims could go forward

# **DURA ON REMAND**

## **◆ The District Court**

- Plaintiffs amended complaint re medical device claim:**
  - ◆ Misrepresentations inflated price**
  - ◆ Stock price dropped following corrective disclosures made on three different dates**
- Court found loss causation pled: plaintiffs “have explained how the misrepresentations . . . caused economic loss. . . .”**

# THE IMPACT OF DURA

- ◆ Dura has had a significant impact
- ◆ Key areas
  - Pleading
  - Theories of loss causation
    - ◆ Fraud on the market
    - ◆ Materialization
  - How much truth
  - General bad news
  - Source of disclosure
  - Other causes
  - Disclosure before/after price drop

# THE IMPACT OF DURA

## ◆ Pleading

- Generally courts apply Rule 8(a)
- Rule 9(b) “particularity” not required
- Some courts require minimal showing
- Others require facts sufficient to demonstrate causal link



# THE IMPACT OF DURA

## ◆ Pleading -- examples (cont'd)

### – General allegation sufficient:

**Allegation that “Plaintiffs purchased OmniVision securities at artificially inflated prices and suffered damages when revelation of the true facts causes a decline in the value of their shares” held sufficient. In re Omnivision Technologies, 2005 WL 1867717 (N.D. Cal. July 29, 2005)**



# **THE IMPACT OF DURA**

## **◆ Pleading – examples (cont'd)**

### **– Some detail sufficient**

- ◆ Allegation of two price dips following disclosure of true facts reveals “at least some minimal details suggesting the possibility of prior misrepresentations, thus justifying an inference the negative effects on Unumprovident’s share price reflected the market’s reaction to this acknowledgement.”  
In re Unumprovident Corp. Sec. Lit., 2005 WL 2206727 (E.D. Tenn. Sept. 12, 2005)**

# THE IMPACT OF DURA

## ◆ Pleading – requirements

- Requiring that loss causation be pled with sufficient specificity: Teachers' Retirement System of LA. v. Hunter, 477 F.3d 162 (4<sup>th</sup> Cir. 2007)
- ◆ While the court did not require “particularity” as per PSLRA or Rule 9(b), it did seem to require more than Rule 8(a). Noting that loss causation as required by the PSLRA is an “averment of fraud,” the court noted that a strong argument can be made that it must be pled with particularity. The court went on to note that “we conclude that a plaintiff purporting to allege a securities fraud claim must not only prove loss causation . . . but he must also plead it with sufficient specificity to enable the court to evaluate whether the necessary causal link exists.”

# THE IMPACT OF DURA

## ◆ Theories of proof of loss causation

- Some courts have held that Dura did not establish what is sufficient, only what is not. See, e.g., In re Initial Pub. Offering Sec. Litig., 2005 WL 1529659 (S.D.N.Y. June 28, 2005); In re The Warnaco Group, Inc. Sec. Litig., 388 F. Supp. 2d 37, 317 (S.D.N.Y. 2005); In re Coca-Cola Enterprises, Incl Sec. Litig., 2007 WL 472943 (N.D. Ga. Feb. 7, 2007); Marsden v. Select Medical Corp., 2007 WL 1725204 (E.D. Pa. June 12, 2007).



# THE IMPACT OF DURA

## ◆ Theories of proof for loss causation (cont'd)

– Others have held there are theories beyond Dura: Ray v. Citigroup Global Mrkets, 482 F.3d 991 (7<sup>th</sup> Cir. 2007)

◆ Fraud suit against investment advisor for fraudulent advice

◆ District court dismissed and 7<sup>th</sup> Circuit affirmed

# THE IMPACT OF DURA

## ◆ Theories of proof – Citigroup Global (cont'd)

### – Three ways to establish loss causation

- ◆ Fraud on the market. This is the standard used in Dura. It requires proof of an artificial price and a decline in value when the truth is revealed
- ◆ Materialization of risk standard. This requires plaintiff to prove that “it was the very facts about which the defendant lied which caused its injuries”
- ◆ Representation that investment is risk free. Requires an explicit representation that the investment is risk free. Here, there was no proof on any of these theories

# THE IMPACT OF DURA

## ◆ Theories of proof - fraud on the market (cont'd)

- Price inflation plus reliance on the integrity of the market is typically insufficient; e.g.

- ◆ In re Business Objects S.A. Sec. Litg., 2005 WL 1787806 (N.D. Cal. July 27, 2005). Claim insufficient: “Plaintiffs and the class have suffered damages in that, in reliance on the integrity of the market, they paid inflated prices for Business Objects’ publically traded securities.” See also Reding v. Goldman Sachs & Co., 382 F. Supp. 2d 1112, 1126 (E.D. Mo. 2005)



# THE IMPACT OF DURA

## ◆ Theories of proof – fraud on the market (cont'd)

– Bankruptcy announcement insufficient to reveal truth: D.E. & J Ltd. Partnership v. Conaway, 133 Fed. Appx. 994, 999-1000 (6<sup>th</sup> Cir. 2005)

- ◆ Stock price claimed to be inflated by concealing true financial condition
- ◆ Filing for bankruptcy is followed by stock price drop
- ◆ Held: that “a stock price dropped on a particular day, whether as a result of a bankruptcy or not, is not the same as an allegation that a defendant’s fraud caused the loss.”

# THE IMPACT OF DURA

## ◆ Theories of proof – fraud on the market (cont'd)

- Failure to specifically allege sold stock at a loss will result in dismissal. Knollenberg v. Harmonic, 152 Fed. App. 674 (9<sup>th</sup> Cir. 2005)
  - ◆ Class action based on merger
  - ◆ Financial data about acquirer false
  - ◆ Complaint claims that stock price fell, but not that plaintiffs sold at a loss
- See also, Glaser v. Enzo Biochem, Inc., 474 F.3d (4<sup>th</sup> Cir. 2006) (same, in a common law fraud case)

# THE IMPACT OF DURA

- ◆ Theories of proof – fraud on the market (cont'd)
  - Specific fraud must be revealed. Tricontinental Ind. v. PWC, 475 F.3d 824 (7<sup>th</sup> Cir. 2007)
    - ◆ Plaintiff sold assets to defendant for stock
    - ◆ Relied on 1997 financial statements
    - ◆ In 2000, defendant announced investigation of possible accounting irregularities for 1998-1999; stock price drops
    - ◆ Dura “stresses that the complaint must ‘specify’ each misleading statement . . . and that there must be a causal connection . . . .”
    - ◆ General acknowledgement of “accounting irregularities” not sufficient

# THE IMPACT OF DURA

## ◆ Theories of proof - Materialization

– Defined: Glover v. Deluca, 2006 WL 2850448 (W.D. Pa. Sept 29, 2006):

“There are two methods of establishing loss causation . . . where the alleged misstatement conceals a condition or event which then occurs and causes the plaintiff’s loss, it is the materialization of the undisclosed condition or event that causes the loss.”

# THE IMPACT OF DURA

## ◆ Theories of proof – Materialization – Glover (cont'd)

### – Second method (fraud on the market)

- ◆ “By contrast, where the alleged misstatement is an intentionally false opinion, the market will not respond to the truth until the falsity is revealed, i.e., a corrective disclosure.”
- ◆ “To use the materialization theory, the first step is to identify the . . . risk concealed . . . .”
- ◆ That specific risk must “materialize”



# THE IMPACT OF DURA

## ◆ Theories of proof – Materialization (cont'd)

– Requirements: In re Williams Securities Litig.,  
2007 WL 2007987 (N.D. Okla. July 6, 2007)

- ◆ “The concept of materialization of the risk [that truth has been concealed is a] method of proof of loss causation [but if truth] gradually leaks out and the effects of the relevant truth (e.g., facts which expose the fraud . . .) cannot be differentiated from bad news unrelated to the fraud,” the theory fails.
- ◆ Plaintiff “must provide proof that the market recognized a relationship between the event disclosed and the fraud.”

# THE IMPACT OF DURA

## ◆ Theories of proof – Materialization (cont'd)

– Actual fraud must materialize: In re Initial IPO Sec. Lit., 2005 WL 1162445 (S.D.N.Y. May 6, 2005)

- ◆ Claim that defendants discounted earnings estimates so companies could beat estimates
- ◆ Share price became inflated
- ◆ Plaintiffs claim truth revealed when failed to meet earnings and financial statements available
- ◆ Court rejects claim: “The fact that an event—in this case a failure to meet earnings forecasts or a statement foreshadowing such a failure—disabused the market of the belief does not mean that the event disclosed the alleged scheme to the market.”

# THE IMPACT OF DURA

- ◆ Theories of proof – Materialization (cont'd)
  - Judge Scheindlin clarified her IPO ruling when denying a motion for reconsideration:
    - ◆ “Because plaintiffs do not allege that the scheme was ever disclosed, they fail to allege loss causation.”

# THE IMPACT OF DURA

## ◆ Theories of proof – Materialization (cont'd)

- Sufficient if concealed risk appears: Teamsters Local 445 v. Bombardier, 2005 WL 218919 (S.D.N.Y. Sept 6, 2006)

- ◆ Plaintiff claim misrepresentations and omissions regarding integrity of underwriting standards for securitized interests in pool of mortgages
- ◆ Exceedingly high delinquency rate causes price drop
- ◆ Judge Scheindlin, who wrote IPO, holds loss causation pled corrective disclosure not required where concealed fact materializes

# **THE IMPACT OF DURA**

## **Theories of proof – Materialization (cont'd)**

- Concealed scheme revealed: In re Parmalat Sec. Lit., 376 F. Supp 2d 472, 510 (S.D.N.Y 2005).**

**Defendants engaged in sham transactions to aid defendant in concealing true financial condition**

**Scheme involved worthless invoices and concealed fact defendant could not pay debt**

**Increasing deficiency rate emerges**

**Judge Kaplan held loss causation sufficient at this stage**

# THE IMPACT OF DURA

## ◆ How much truth?

– Revealing part of fraud sufficient: In re Retek Sec. Lit., 2005 WL 3059566 (D. Minn. Oct. 21, 2005)

- ◆ Complaint alleges financial fraud involving 4 deals
- ◆ Stock price drops when press release disclosed one deal
- ◆ “While the thread of causation may be long and somewhat tortured, at this stage . . . Plaintiffs have alleged enough . . . [there is] a corrective disclosure followed by a drop in the stock price . . .”

# THE IMPACT OF DURA

## ◆ How much truth? (cont'd)

- **Separate schemes: In re St. Paul Travelers Sec. Lit. II, 2007 WL 1589524 (D. Minn. June 1, 2007).**
  - ◆ Complaint alleged two separate schemes
  - ◆ One revealed by state AG
  - ◆ Held: Dura satisfied as to one scheme. “In essence, lead plaintiff’s position is that a corrective disclosure about any questionable conduct that impacts a company’s financial statements is sufficient . . . [this] would create a boundless rule, rendering meaningless the loss causation requirement . . .”
- **See also, Marsden v. Select Meidical Corp., 2007 WL 1725204 (E.D. Pa. June 12, 2007) (same)**

# THE IMPACT OF DURA

## ◆ General bad news

– General economic conditions: In re Acterna Corp. Sec. Lit., 378 F. Supp. 2d 561 (D. Md. 2005)

- ◆ Shares purchased at an inflated price because defendants fraudulently failed to write down good will from acquisitions
- ◆ Share price dropped 94% during class period



# THE IMPACT OF DURA

## ◆ General bad news – Acterna (cont'd)

- ◆ Held: failure to plead loss causation: “Not only do plaintiffs not allege that the rapid decline in Acterna’s share price was caused in some way by Defendant’s alleged misrepresentations or omissions, their complaint suggests otherwise, alleging that prior to the class period, the global communications industry experienced a severe economic slow down that continued throughout the Class Period . . . .”
- ◆ See also, In re Tellium, Inc. Sec. Lit., 2005 WL 1677467 (D. N.J. June 30, 2005) (same)

# THE IMPACT OF DURA

## ◆ Source of truth

- Truth does not have to come from company: In re Winstar Comm., 2006 WL 473885 (S.D.N.Y. Feb 27, 2006)
  - ◆ Complaint: financials false; misrepresentations about financial status/relationship with vendor
  - ◆ Analyst report based on public information reveals truth and stock price drops
  - ◆ Held: sufficient to plead loss causation. “The key to this [materialization] is the veracity of the information, not the source.” The fact that the report is from public information “does not mean that a reasonable investor could have drawn those same conclusions.”

# THE IMPACT OF DURA

## ◆ Other causes

– “If one substantial cause,” sufficient: In re Daou Systems, Inc. Sec. Lit., 411 F.3d 1006 (9<sup>th</sup> Cir. 2005)

- ◆ Financial fraud case where overstated revenue
- ◆ By 3<sup>rd</sup> quarter financial condition deteriorating; when 3Q results announced, stock price dropped
- ◆ Company failed to disclose actual figures to analysts prior to releasing third quarter results to avoid disclosure
- ◆ Analyst report suggested “cooking books”

# THE IMPACT OF DURA

## ◆ Other causes — Daou Systems (cont'd)

- “To establish loss causation plaintiff must demonstrate a causal link between the fraud and the injury suffered. Plaintiff is not required to show that the misrepresentation was the sole cause. Rather, plaintiff must only demonstrate that it is ‘one substantial cause’ for the decline in value of the shares. The fact that there are other contributing causes will not bar the recovery.”

# THE IMPACT OF DURA

## ◆ Other causes (cont'd)

- Need not exclude all other causes: In re Geopharma Inc. Sec. Lit., 2005 WL 2431518 (S.D.N.Y. Sept. 30, 2005)
  - ◆ Fraud case based on claim that press release wrongly represented FDA-approved drug when it actually approved device
  - ◆ Judge Scheindlin: “Defendants overstate the nature of plaintiffs’ burden at this stage of the proceedings when they argue that plaintiffs must exclude all other possible causes of the artificial inflation. To the contrary, plaintiffs must only allege a false or misleading statement, which caused an artificial inflation of the stock, followed by a dissipation of that inflation after corrective disclosures were made.”



# THE IMPACT OF DURA

## ◆ Other causes – Bristol Myers (cont'd)

– Court: Complaint sufficient:

◆ “First, the argument cannot be disproved. According to Defendants’ logic, Plaintiff would not be able to show loss causation without proving that investor rejected the possibility that what appeared to be the ‘truth’ was actually a mistake.”

◆ “Second . . . a plaintiff would have to adduce sufficient evidence that the alleged corrective disclosure, not only revealed a concealed truth, but also, that the market perceived it as a corrective disclosure and reacted to that perception. Thus, if Defendant’s argument prevails, a plaintiff must prove that it was the perception of the alleged corrective disclosure not necessarily the subject of the disclosure that caused the share price to drop. This is an impossible burden to satisfy and cannot be required by Dura.”

# THE IMPACT OF DURA

## ◆ Before/after

– Facts disclosed before price drop not sufficient: Teachers' Retirement System of LA. v. Hunter, 477 F.3d 162 (4<sup>th</sup> Cir. 2007)

- ◆ Complaint alleged financial fraud re channel stuffing and round trip transactions
- ◆ Truth revealed according to plaintiffs in a lawsuit



# THE IMPACT OF DURA

## ◆ Before/after – Hunter (cont'd)

- Court affirmed dismissal, concluding the lawsuit “discloses nothing new, but merely attributes an improper purpose to the previously disclosed facts.”
- “To allege loss causation in this case, plaintiffs would have to allege that the market reacted to new facts disclosed . . . .”  
but here no new facts were revealed

# THE IMPACT OF DURA

## ◆ Before/after (cont'd)

- Decline before truth comes out insufficient: Schleider v. Wendt, 2005 WL 1656871 (S.D. Ind. July 14, 2005)

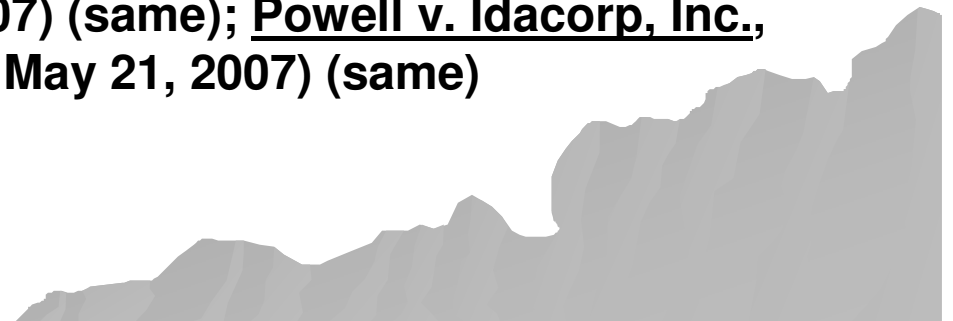
- ◆ Suit claim false statements about operations during class period

- ◆ Continual price decline during period

- ◆ After class period, bankruptcy and later truth comes out

- ◆ Held: No loss causation: “The stock had long since hit bottom before these alleged misrepresentations became known.”

- ◆ See also, In re Coca-Cola Enterprises, Inc. Sec. Lit., 2007 WL 472943 (N.D. Ga. Feb. 7, 2007) (same); Powell v. Idacorp, Inc., 2007 WL 1498881 (D. Idaho May 21, 2007) (same)



# CONCLUSION

- ◆ Dura has had a significant impact on private securities litigation
- ◆ Under Dura there are three basic options for pleading loss causation
- ◆ While Rule 8(a) notice pleading applies, many courts require more than general allegations
- ◆ Dura has increased the burden of pleading a private securities fraud complaint