Proving Causation in Federal Securities Litigation Cases: Dura Pharmaceuticals, Inc. vs. Broudo

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Abstract

To recover damages in a private cause of action under section 10(b) of the Securities Exchange Act of 1934 and under rule 10b-5 promulgated by the Securities and Exchange Commission, a plaintiff must plead and prove causation. Specifically, plaintiff must plead and prove both transaction causation and loss causation. However, loss causation is one of the most difficult elements to prove in securities fraud cases.Because loss causation is not easily defined, its concept had proved to be quite elusive. Not surprisingly, analysis of loss causation manifested confusion and uncertainty among the federal circuit courts for years, where two distinct approaches to the concept of loss causation existed prior to the Supreme Court's decision of Dura Pharmaceuticals, Inc. vs. Michael Broudo.*JEL Codes: K20 and K22.*

1. Introduction

To recover damages in a private cause of action under section 10(b) of the Securities Exchange Act of 1934 and under rule 10b-5 promulgated by the Securities and Exchange Commission, a plaintiff must plead and prove loss causation (Binder v. Gillespie, 1999). However, loss causation is one of the most difficult elements to prove in securities fraud cases (Nowicki, 2004). Because loss causation is not easily defined, its concept has proved to be quite elusive. Not surprisingly, analysis of loss causation manifested confusion and uncertainty among the courts, where two distinct approaches to the concept existed, prior to the Supreme Court's decision of Dura Pharmaceuticals, Inc. v. Michael Broudo.

While circuits agree that loss causation refers to a causal link between plaintiff's injury and defendant's conduct, they disagree on how strong that link should be (Escoffery, 2000). As a result, theories of loss causation became distorted in federal securities cases, resulting on a split among the circuits on the application of this element of the claim (Bard, 1992). The Supreme Court had finally recognized the need to eliminate this confusion and clarified the concept of loss causation.

2. Literature Review

Congress passed Securities Exchange Act of 1934 as a response to 1929 stock market crash. The purpose of the Act was to improve accuracy of securities information and deter fraud (Escoffery, 2000). Specifically, the provisions if the Act were aimed at discontinuing manipulative and deceptive trading practices that existed prior to the stock market crash. The general antifraud provisions of the Act were aimed at restoring investors' confidence in the securities market (Escoffery, 2000). Basically, section 10(b) of the Act made it unlawful for any persons to use, in connection with sale or purchase of securities, any deceptive practices in violation of the rules promulgated by the Securities Exchange Commission.

Subsequently, in 1942, pursuant to authority under section 10(b), Securities Exchange Commission promulgated rule 10b-5 to further extend investors' protections. Rule 10b-5 was designed to combat fraudulent practices, including material misrepresentations or omissions. Although the rule did not expressly grant investors a right to a private remedy, separate from a cause of action brought by the Securities Exchange Commission, the Supreme Court had implied a private cause of action from the provisions of 10b-5 (Superintendent of Insurance v. Bankers Life and Casualty Co., 1971). As a result, this rule has become the principle means used by private investors to recover for fraudulent practices of the management (Escoffery, 2000).

Finally, in 1995, Congress enacted Private Securities Litigation Reform Act, again aiming at diminishing abusive practices in the securities litigation cases. However, the main goal of this Reform Act was to protect defendant-management from frivolous suits (Escoffery, 2000).

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As such, this Reform Act added section 21D(b)(4) to the 1934 Act, which expressly included a causation requirement for the private cause of action under rule 10b-5. Section 21D(b)(4) provides that "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." However, even though the statute now expressly required plaintiffs to prove causation, it did not provide a clear approach to determining whether plaintiffs had successfully established the required causal link between his injury and defendants' fraudulent conduct (Escoffery, 2000).

3. The Methodology and Model

Although the Supreme Court had never expressly defined all of the necessary elements of an action under 10b-5, courts agree that a plaintiff bringing a private action under 10b-5 must prove that a defendant, (a) in connection with sale or purchase of security, (b) made material misrepresentations or omissions with scienter, that plaintiff (c) relied on those misrepresentations or omissions, and (d) those misrepresentations or omissions caused plaintiff to suffer actual damages (Binder v. Gillespie, 1999). Furthermore, in order to satisfy the requirement of causation, courts agree that a plaintiff must plead and prove both transaction causation and loss causation (Gray v. First Winthrop Corp., 1996).In order to establish transaction causation, plaintiff must prove that defendant's fraudulent conduct had caused him to enter into the transaction in question. This part of the causation requirement is often compared to the "but for" negligence test (Escoffery, 2000). Therefore, in order to establish transaction causation, plaintiff must prove that but for defendant's misrepresentations or omissions, plaintiff would not have invested in the stock or kept it when the price was declining. Some courts, however, treat transaction causation as merely way of proving reliance (Nowicki, 2004). Since most of the publicly available information is reflected in the market price of securities, an investor's reliance on that information, including any material misrepresentations or omissions made by the management, can be presumed for the purposes of a private cause of action under 10b-5 (Nowicki, 2004).

Finally, in order to establish loss causation, plaintiff must prove the existence of a causal link between his injury and defendant's misrepresentations or omissions (Gray v. First Winthrop Corp., 1996). Loss causation is often compared to the proximate cause analysis of the negligence test (Escoffery, 2000). When a direct causal connection exists between the defendant's conduct and the plaintiff's injury, the establishment of the causation element is simplified (Hazen, 2002). However, when the causal link is weakened by a series of collateral breaches of fiduciary duty, loss causation is harder to define (Hazen, 2002). Nevertheless, the definition of loss causation is essential because it directly affects the extent of a plaintiff's burden of proof. Since the circuits that require a more direct causal link between the plaintiff's injury and defendant's wrongdoing, make it more difficult for the plaintiff to prove loss causation and then to recover damages, a court's view on loss causation can be the principle determinant in assessing defendant's liability. However, despite the importance of pleading proving causation, the analysis of this element manifests confusion and uncertainty among the courts, where two distinct approaches to the concept of loss causation existed (Escoffery, 2000).

4. Discussion

Prior to the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*, courts were divided on the issue of how to approach loss causation in private causes of action brought under rule 10b-5 (Escoffery, 2000). While circuits agreed that loss causation represents a causal nexus between a plaintiff's injury and defendant's misconduct, they disagreed on how direct this connection must be (Escoffery, 2000). Circuits also agreed that if such connection between the wrongful conduct and the alleged injury is so weakened by a series of intervening causes that the injury could no longer be traced to the wrongful conduct, no recovery is warranted (Gray v. First Winthrop Corp., 1996). However, some circuits adopted a definition of loss causation more favorable to the plaintiffs, requiring that plaintiffs prove only that the stock price at the time of purchase was overstated and that there was a sufficient identification of the cause of the price drop (Gebhardt v. ConAgra Foods, Inc., 2003). Such definition of loss causation does not require plaintiffs to prove that the price drop followed a corrective statement. For example, courts in the Eight and Ninth Circuits have held that inflated price at the time of purchase of the securities was enough to prove loss causation. Other circuits, on the other hand, adopted a definition of loss causation more favorable to defendants, expecting plaintiffs to prove a more direct causal connection between injury and the alleged wrongful conduct (Escoffery, 2000). To illustrate the concept further, courts in the Fourth, Fifth, Sixth, and Eleventh Circuits have held that inflated price at the time of purchase of the securities is not enough to establish loss causation.

In such circuits, to prove loss causation, plaintiffs must demonstrate that there was a corrective statement that was followed by a stock price decline (Escoffery, 2000). Furthermore, the corrective statement would have to show that the previous statements, on which a plaintiff relied and because of which such plaintiff purchased securities, were in fact false or misleading. Thus, to prove loss causation, a plaintiff has to establish that the stock price decline occurred after defendants had publicly corrected their previous misrepresentations, and that the price drop was directly attributable to the corrected misrepresentation (Escoffery, 2000). Recently, in Broudo v. Dura Pharmaceuticals, Inc., the United States District Court for the Southern District of California adopted a definition less favorable to the plaintiffs and dismissed their complaint, stating that the plaintiffs had failed to prove loss causation. On appeal, however, the Ninth Circuit reversed and remanded, adopting a definition of loss causation that is more favorable to plaintiffs. Because the issue created a split in the federal circuits, Supreme Court granted certiorari and on April 19th of 2005, reversed (Dura Pharmaceuticals, Inc. v. Broudo, 2003).

A. Dura Pharmaceuticals, Inc. v. Broudo

Plaintiffs brought the original suit in the district court on behalf of investors who purchased Dura Pharmaceuticals securities.Plaintiffs brought this action under section 10(b) and rule 10b-5 alleging that Dura Pharmaceuticals' management made false and misleading statements with regard to the asthma medication device by stating that FDA's approval of the device was imminent. Specifically, plaintiffs alleged that because of these false and misleading statements, they invested in an inflated stock, the price of which later declined dramatically and caused them to suffer a substantial economic loss (Dura Pharmaceuticals, Inc. v. Broudo, 2003). California district court dismissed plaintiff's claim, stating that plaintiffs had failed to establish loss causation. The court reasoned that defendants' misstatements or omissions could not have caused the decline in the price of the company's stock because the corrective statement, announcing that FDA did not approve the company's asthma medication device, was not followed by the decline in the value of the stock.

Plaintiff appealed to the Court of Appeals for the Ninth Circuit making similar allegations. On appeal, the court once again reviewed the facts giving rise to the plaintiff's cause of action (Dura Pharmaceuticals, Inc. v. Broudo, 2003).

B. Relevant Material Facts

Between April of 1997 and November of 1998, Dura Pharmaceuticals issued a series of press releases, stating that they were developing a new device used to dispense asthma medication, which would no longer make in necessary for the patients to inhale at the exact moment the medicine was dispensed. On July 15th, 1997, during a press release, Dura Pharmaceuticals announced that the company was continuing to demonstrate its capacities as a respiratory market force, which the company claimed was evident from the ongoing growth of its products. At that time, the company's stock had reached its high of $53 per share. Then, on February 24, 1998, Dura Pharmaceuticals revealed that it expected lower 1998 revenues then it had anticipated earlier. On that day, Dura Pharmaceuticals suffered a 47% one-day decline on a volume of 32 million shares. Throughout the remainder of 1998, Dura Pharmaceuticals' business had steadily declined. On April 16th of 1998, during a conference call, Dura Pharmaceuticals' management revealed that as early as December of 1997, the company's sales had been declining. Finally, in November of 1998, Dura Pharmaceuticals revealed that FDA will not approve its asthma medication device because of the electro-mechanical reliability issues as well as chemistry, manufacturing and control concerns (Dura Pharmaceuticals, Inc. v. Broudo, 2003).

On appeal, the Ninth Circuit held that plaintiffs had sufficiently pled and proved both transaction and loss causation. The court held that in order to establish causation element required under rule 10b-5, plaintiff must prove both transaction and loss causation. The Ninth Circuit stated that to prove transactioncausation, plaintiff must show that false statements or omissions caused plaintiff to engage in the transaction in question. Therefore, plaintiffs must establish that but for defendants' misrepresentations, they would not have invested in the company's stock. On appeal, plaintiffs were able to convincingly establish transaction causation. But for Dura Pharmaceuticals' announcement of its new revolutionary asthma medication device and its imminent approval by the FDA, they would not have invested in Dura Pharmaceuticals and would not have kept the stock when its price started to decline (Dura Pharmaceuticals, Inc. v. Broudo, 2003). Furthermore, as to loss causation, the Ninth Circuit also held that plaintiffs sufficiently had pled and proved loss causation.To establish loss causation, the court stated, plaintiffs must show that defendant's misrepresentations "touched upon" the reasons for the investment's decline in value.

Thus, the court adopted a definition of loss causation that was less favorable to defendant Dura Pharmaceuticals and held: "Loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause" (Dura Pharmaceuticals, Inc. v. Broudo, 2003). Applying such definition, the court found that plaintiffs had sufficiently proved the element of loss causation. The Ninth Circuit reasoned that even though the 47% decline in value of the company's stock did not follow the corrective statement acknowledging that FDA will not approve Dura Pharmaceuticals' new asthma medication device, plaintiffs had successfully proved loss causation because, due to Dura Pharmaceuticals' misrepresentations, the value of the company's stock was overvalued. As such, the Ninth Circuit reversed the district court's dismissal and held that plaintiffs had successfully established the element of causation(Dura Pharmaceuticals, Inc. v. Broudo, 2003).

C. Supreme Court's Decision

As discussed above, due to the split in the federal circuits, Supreme Court granted certiorari and on April 19th of 2005, reversed. The Supreme Court had rejected the Ninth Circuit's argument that the price drop need not follow a corrective statement. In the unanimous decision, the Court stated: "In our view, the Ninth Circuit is wrong, both in respect to what the plaintiff must prove and in respect to what the plaintiffs' complaint here must allege" (Dura Pharmaceuticals, Inc. v. Broudo, 2005). Specifically, the Supreme Court had noted that at the moment the transaction takes place, the plaintiff had not suffered any loss yet. Furthermore, the Court stated that the shares are usually purchased with the hope that they will increase in value and with the idea that they will be sold later at a profit.Therefore, in order to prove causation element, plaintiffs must prove proximate causation and economic loss.

As such, the Court has held that proving that the price of stock on date of purchase was inflated because of misrepresentation was insufficient by itself to establish loss causation required by rule 10b-5. The Court's holding, therefore, established a requirement for a more direct causal link between the alleged misrepresentations or omissions and plaintiffs' damages (Dura Pharmaceuticals, Inc. v. Broudo, 2005). Since the stock price drop has to follow the corrective statement, the Supreme Court seems to suggest that plaintiffs in Dura Pharmaceuticals' case would have been more successful in establishing loss causation if they would have sold the stock right after the press release that FDA will not be approving the company's asthma medication device and sued for the decline in the stock price at that time.

D. Choosing a Superior Definition of Loss Causation

Clearly, plaintiffs in Dura Pharmaceuticals' case sustained a substantial economic loss. They suffered a sharp decline in the value of their investment when the company's stock underwent a 47% one-day decline on a volume of 32 million shares. Moreover, defendant Dura Pharmaceuticals also made material misrepresentations and omissions, on which plaintiffs relied. During its press releases, Dura Pharmaceuticals claimed that FDA's approval of its new asthma medication device was imminent and stated that its sales were increasing, when, in fact, it knew otherwise. (Dura Pharmaceuticals, Inc. v. Broudo, 2003). Finally, plaintiffs represented a large group of investors, all of whom relied to their detriment on the company's misrepresentations and purchased stock at an inflated price.

However, in order to bring a private cause of action under section 10(b) and rule 10b-5, plaintiffs must prove a causal link between the injury they suffered and defendants' misrepresentations (Escoffery, 2000). Without that causal link, no matter how grave the injuries are, plaintiffs' recovery could not be warranted (Nowicki, 2004). Nonetheless, the definition of loss causation adopted by the Ninth Circuit afforded recovery to plaintiffs without proof of any such causal link (Dura Pharmaceuticals, Inc. v. Broudo, 2003). After all, the injury that plaintiffs allege, a 47% price drop in the company's stock could be partially attributed to events other then FDA approval, such as the company's lower-than-forecasted revenues and decreases in sales of the company's other products. Moreover, the corrective statement that FDA will not approve the company's new asthma medication device was made after the stock price had already decreased dramatically(Dura Pharmaceuticals, Inc. v. Broudo, 2003). Therefore, the causal connection between the wrongful conduct and the alleged injury was so weakened by a series of intervening causes, such as decline in sales of Dura Pharmaceuticals' other products, that plaintiffs' injury could no longer be traced to the defendant's wrongful conduct. The statement acknowledging the drop in the sale of the company's other products served as a superseding cause that destroyed the causal connection between the alleged misconduct and plaintiffs' injury.

Based on the argument above, the district court for the Southern District of California also held that plaintiffs failed to prove loss causation (Dura Pharmaceuticals, Inc. v. Broudo, 2001). Unlike the appellate court, district court held that an inflated purchase price alone was not sufficient to establish loss causation. The district court held that since the 47% drop in the stock price did not follow a corrective statement disclosing that FDA will not approve the company's new medication device, the injury was not caused by defendants' misrepresentations (Dura Pharmaceuticals, Inc. v. Broudo, 2001).

There are four reasons why district court's definition of loss causation is the most favorable one. First, by adopting a loss causation definition requiring plaintiffs to prove only that the stock price at the time of purchase was overstated, the Ninth Circuit effectively eliminated the loss causation requirement. Second, both the provisions and the Congressional intent behind the Private Litigation Reform Act of 1995 support the distinct court's approach to loss causation, requiring proof of direct causal connection between plaintiffs' injury and defendants' misconduct. Third, the purchase of securities at an inflated price will not necessarily lead to an economic loss. Fourth, the Supreme Court held that Ninth Circuit's definition of loss causation lacked support in precedent, where other circuits have rejected the inflated purchase price definition and adopted a definition more favorable to the defendants. As such, establishing that the price of the stock was inflated at the time of purchase, alone is not enough to prove the requirement of the loss causation under rule 10b-5.

5. Conclusion

To recover damages in a private cause of action under section 10(b) of the Securities Exchange Act of 1934 and under rule 10b-5 promulgated by the Securities and Exchange Commission, a plaintiff must plead and prove loss causation (Binder v. Gillespie, 1999). However, loss causation is one of the most difficult elements to prove in securities fraud cases (Nowicki, 2004). Due to the recent Supreme Court decision of Dura Pharmaceuticals, Inc. v. Broudo, loss causation can only be established by proving a directed causal link between the defendant's misrepresentations and plaintiffs' injury, where proving that the price was inflated at the time of purchase alone is not sufficient.

References

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