No. 03-932

In the Supreme Court of the United States

DURA PHARMACEUTICALS, INC., ET AL., PETITIONERS

v.

MICHAEL BROUDO, ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES
AS AMICUS CURIAE SUPPORTING PETITIONERS

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QUESTION PRESENTED

Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price.

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INTEREST OF THE UNITED STATES

The United States, through the Department of Justice (Department) and the Securities and Exchange Commission (Commission), administers and enforces the federal securities laws. The issue in this case is the appropriate standard of loss causation in a private securities-fraud action in which the plaintiff invokes the fraud-on-the-market theory. Private securities-fraud actions are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department and the Commission, and the United States has a strong interest in seeing that the principles applied in such actions promote the purposes of the securities laws. The United States filed a brief at the petition stage of this case at the invitation of the Court.

STATEMENT

1. a. Petitioner Dura Pharmaceuticals, Inc. (Dura) developed and marketed products for the treatment of allergies, asthma, and other respiratory conditions. Pet. App. 2a n.1. In 1995, it began developing an asthma-drug delivery device called Albuterol Spiros. *Id.* at 19a-20a. The following year, it began selling a respiratory antibiotic called Ceclor CD. *Id.* at 41a. In an April 15, 1997, press release announcing better-than-expected results for the first quarter of 1997, Dura stated that "strong progress" had been made in selling Ceclor CD, and that "[p]atient dosing" had been completed for the Albuterol Spiros clinical trials that were necessary before a new drug application (NDA) could be submitted to the Food and Drug Administration (FDA). *Id.* at 3a. Dura filed the NDA for Albuterol Spiros in November 1997. *Id.* at 4a.

On February 24, 1998, Dura announced that, for a number of reasons, including slower than expected sales of Ceclor CD, it was anticipating lower revenues and earnings per share in 1998 than had previously been forecast. The next day, the price of Dura stock dropped to $20 3/4 from $39 1/8, a 47% one-day loss. The February 24 announcement did not mention Albuteros Spiros. Pet. App. 5a, 7a, 40a.

Dura's business declined throughout the remainder of 1998. Pet. App. 5a. In November 1998, Dura announced that the FDA had declined to approve Albuteros Spiros, "due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns." *Ibid.* Although the complaint in this case does not allege any decline in Dura's stock price after the November 1998 disclosure, it is a fact that, following the announcement and well after the end of the class period, the price of Dura stock dropped from $12 3/8 to $9 3/4. Pet. 3 n.4; Pet. C.A. Supp. E.R. Tab 79, Exh. L. Within 12 trading days, however, the stock was again selling at nearly $12 1/2. *Ibid.*

b. Respondents, shareholders who purchased Dura stock between April 15, 1997, and February 24, 1998, filed several securities-fraud class actions against Dura and a number of its senior officers and directors, who are also petitioners here. After the complaints were consolidated and amended, the district court dismissed the resulting complaint without prejudice. Respondents then filed a second consolidated amended complaint (complaint). It alleged that petitioners made false and misleading statements about Dura's performance during the class period, and thereby violated Section 10(b) of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, as well as Section 20(a) of the 1934 Act, 15 U.S.C. 78t(a), the "controlling person" provision. Pet. App. 2a, 5a-6a, 18a-19a.

According to the complaint, petitioners made misrepresentations concerning a number of different aspects of Dura's business, only two of which are still at issue: sales of Ceclor CD and the development of Albuterol Spiros. Respondents alleged that petitioners deliberately misled the investing public into believing that the sales of Ceclor CD and the prospects for Albuterol Spiros were better than they in fact were. Respondents relied on the fraud-on-the-market theory, see *Basic Inc.* v. *Levinson*, 485 U.S. 224, 241-249 (1988), which establishes a rebuttable presumption that investors rely on a material misrepresentation made to the public. Pet. App. 2a-3a, 6a-7a, 12a, 27a, 34a-39a, 41a-44a; Resp. C.A. E.R. Tab 72, at 85 (¶ 179).

2. The district court granted petitioners' motion to dismiss. Pet. App. 18a-51a. It held that the allegations concerning Ceclor CD did not satisfy the pleading requirements for Rule 10b-5 claims, because they did not adequately demonstrate that the challenged statements were made with scienter. *Id.* at 45a-47a. It held that the allegations concerning Albuterol Spiros failed to state a claim under Rule 10b-5, because they did not satisfy the element of loss causation, which means that "the misrepresentations or omissions caused the harm." *Id.* at 39a-40a (quoting *Binder* v. *Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999), cert. denied, 528 U.S. 1154 (2000)). It held that the "controlling person" allegations must be dismissed, because such a claim requires "a primary violation" that was absent here. *Id.* at 50a. And it ordered that the dismissal be with prejudice, because respondents had already had an opportunity to amend the complaint to satisfy the applicable pleading requirements. *Id.* at 51a.

In holding that the Albuterol Spiros allegations did not satisfy the element of loss causation, the district court reasoned that Dura's announcement on February 24, 1998, did not "contain[] any negative information about Albuterol Spiros"; that "Dura did not announce that the FDA would not approve Albuterol Spiros until nine months later, in November 1998"; and that the complaint therefore "does not contain any allegations that the FDA's non-approval had any relationship to the February price drop." Pet. App. 40a. Rather than having a connection with "the alleged misrepresentations and omissions regarding Albuterol Spiros," the court said, "the decline in Dura's stock price" on February 24 "was the result of an expected revenue shortfall." *Ibid.*

3. The court of appeals reversed and remanded for further proceedings. Pet. App. 1a-17a. With respect to the Ceclor CD allegations, the court of appeals held that, although the district court correctly concluded that each allegation of scienter was insufficient standing alone, it failed to determine whether the allegations were sufficient when considered collectively. *Id.* at 11a-14a. The court also held that, contrary to the conclusion of the district court, the Albuterol Spiros allegations did satisfy the element of loss causation. *Id.* at 8a-11a. And the court held that respondents should have been granted leave to amend the complaint. *Id.* at 15a-16a & n.6. The court declined petitioners' invitation to affirm on alternative grounds not addressed by the district court. *Id.* at 16a.

In holding that respondents had adequately alleged loss causation, the court of appeals noted that that element is satisfied if the plaintiff shows that "the misrepresentation touches upon the reasons for the investment's decline in value." Pet. App. 8a (quoting *Binder*, 184 F.3d at 1066). While acknowledging the ambiguity of the phrase "touches upon," the court followed a prior decision of the Ninth Circuit holding that a plaintiff in a fraud-on-the-market case establishes loss causation if he shows that "the price on the date of purchase was inflated because of the misrepresentation." *Id.* at 9a (quoting *Knapp* v. *Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996), cert. denied, 519 U.S. 1112 (1997)). "[I]t is not necessary," the court said, "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," which is the time at which "damages are to be measured." *Ibid.* The court thus held that, to satisfy the element of loss causation, a plaintiff need not plead "a stock price drop following a corrective disclosure or otherwise"; he need only plead "that the price at the time of purchase was overstated and sufficient identification of the cause." *Ibid.* The court concluded that the complaint satisfied this requirement, because it alleged that "the price of the stock was overvalued in part due to the misrepresentations * * * that the development and testing of the Albuterol Spiros device were proceeding satisfactorily and that FDA approval of the device was imminent." *Id.* at 10a-11a.

SUMMARY OF ARGUMENT

The district court correctly dismissed respondents' allegations concerning Albuterol Spiros, because respondents failed to plead loss causation—*i.e.*, a causal connection between the alleged fraud and the investment's subsequent decline in value. The Ninth Circuit's standard, which effectively obviates the need to allege loss causation, rests on a mistaken view of when the injury occurs and cannot be reconciled with provisions of the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737.

A. As part of a broader effort to curtail the abusive practices that undermine the beneficial purposes of private securities litigation, Congress amended the 1934 Act in the PSLRA to codify the requirement that the misrepresentation at issue "caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. 78u-4(b)(4). Congress clarified that a misrepresentation and a loss were not sufficient. To recover, a securities-fraud plaintiff must plead and prove that the alleged misrepresentation caused the alleged loss. This requirement of loss causation, which had previously been a judicially inferred element of a Rule 10b-5 cause of action, is to be distinguished from transaction causation, which is a separate element. While transaction causation means that the misrepresentation caused the plaintiff to engage in the securities transaction, loss causation means that the misrepresentation caused the plaintiff economic harm. 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.

B. In the Ninth Circuit, a plaintiff in a fraud-on-the-market case can establish loss causation merely by pleading and proving that he purchased the security at a price inflated by the defendant's misrepresentation. That standard is incorrect. As other circuits have recognized, there is no loss causation in a fraud-on-the-market case unless the truth was subsequently revealed and the inflation attributable to the misrepresentation was thereby removed from the price of the security to the injury of the plaintiff. The truth can be revealed either by a corrective disclosure or by events —for example, the materialization of a risk represented to be absent. The inflation attributable to the untruth will generally be removed through an absolute decline in the price of the security, but could also be removed through an increase in the price that is smaller than it otherwise would have been.

The Ninth Circuit's standard rests on the premise that the loss caused by a misrepresentation occurs at the time of the transaction, when the investor pays "too much" for the security. The premise is mistaken, because an investor can fully recoup his overpayment by reselling the security at the prevailing inflated price, and thus does not suffer *any* loss at the time of the purchase, much less one caused by the misrepresentation. A loss is a decline in value, and in a fraud-on-the-market case, that necessarily occurs at a point in time *after* the purchase. If it were otherwise, a plaintiff who purchased and then resold at the inflated price would recover a windfall; loss causation would be present in every fraud-on-the-market case in which the presumption of reliance was unrebutted; and there would be no practical difference between loss causation and transaction causation.

The Ninth Circuit's standard is also difficult to reconcile with the loss-causation provision that the PSLRA added to Section 12 of the Securities Act of 1933 (1933 Act), which enables a defendant to defeat liability by showing that the amount recoverable represents "other than the depreciation in value of the * * * security" resulting from the misrepresentation. 15 U.S.C. 77*l*(b). Since there is no reason to believe that Congress had two different standards of loss causation in mind when it enacted the PSLRA, it is reasonable to conclude that Congress meant to require a plaintiff in a Rule 10b-5 case to plead and prove that he was injured by a "depreciation in value of the * * * security" that resulted from the misrepresentation. That is different from paying too much at the time of purchase.

C. The allegations of loss causation in the complaint —that respondents "paid artificially inflated prices for Dura securities," Resp. C.A. E.R. Tab 72, at 85 (¶ 179) —may satisfy the Ninth Circuit's standard, but that standard is incorrect. And the complaint does not allege facts that satisfy the correct standard—*i.e.*, that the inflation attributable to the alleged misrepresentations about Albuterol Spiros was removed from the price before respondents sold their Dura stock. Dismissal of that portion of the complaint was therefore proper.

ARGUMENT

RESPONDENTS' ALLEGATIONS CONCERNING ALBUTEROL SPIROS DO NOT SATISFY THE LOSS-CAUSATION REQUIREMENT OF RULE 10b-5, BECAUSE THE COMPLAINT DOES NOT ALLEGE THAT THE INFLATION IN THE PRICE OF DURA STOCK ATTRIBUTABLE TO THE CHALLENGED MISREPRESENTATIONS WAS ELIMINATED OR REDUCED

Section 10(b) of the 1934 Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security * * * , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j(b). The Commission's Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," to (a) "employ any device, scheme, or artifice to defraud"; (b) "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made * * * not misleading"; or (c) "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5. Section 10(b) has been construed to afford an implied right of action to purchasers or sellers of securities who have been injured by its violation. See, *e.g.*, *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 380 & n.10 (1983); *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

In prior cases, this Court has addressed a number of the elements of a private cause of action under Rule 10b-5. See *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988) (materiality and reliance); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (scienter); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975) (purchaser or seller). This case involves the element of causation, or at least one component of it: the requirement, now codified, that the misrepresentation alleged to violate Rule 10b-5 "caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. 78u-4(b)(4). As explained below, the loss-causation standard applied by the court of appeals is incorrect, and respondents' allegations do not satisfy the correct standard.

A. A Private Plaintiff Asserting A Violation Of Rule 10b-5 Must Plead And Prove Loss Causation

Between 1974, when the Second Circuit first adopted the "loss causation" terminology in *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, cert. denied, 421 U.S. 976 (1975), and 1995, when Congress passed the PSLRA, loss causation was generally recognized as a judicially inferred element of a Rule 10b-5 cause of action. The PSLRA codified the loss-causation requirement, making it a statutory element.

1. *Loss causation was initially a judicially inferred element of a Rule 10b-5 cause of action*

Rule 10b-5 is "distinct from common-law deceit and misrepresentation," and indeed was "in part designed to add to the protections provided investors by the common law." *Basic Inc.*, 485 U.S. at 244 n.22 (citing *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. at 744-745, and *Herman & MacLean* v. *Huddleston*, 459 U.S. at 388-389). Courts have often been guided by "common-law doctrines of fraud and deceit," however, in deciding what elements a Rule 10b-5 cause of action comprises, and what must be pleaded and proved to establish them. *Id.* at 253 (opinion of White, J.). That is certainly true of loss causation. As Judge Posner has observed, "what securities lawyers call 'loss causation' *is* the standard common law fraud rule * * *, merely borrowed for use in federal securities fraud cases." *Bastian* v. *Petren Res. Corp.*, 892 F.2d 680, 683 (7th Cir.), cert. denied, 496 U.S. 906 (1990). See Restatement (Second) of Torts § 548A & cmt. b (1977) (Restatement of Torts) (stating loss-causation requirement).

The securities-fraud cases draw a distinction between loss causation and transaction causation. The latter means that the misrepresentation "caused the [plaintiff] to engage in the transaction in question," while the former means that the misrepresentation "caused the economic harm." *Schlick*, 507 F.2d at 380. Transaction causation has been viewed as a synonym for the element of reliance, *e.g.*, *Harris* v. *Union Elec. Co.*, 787 F.2d 355, 366 (8th Cir.), cert. denied, 479 U.S. 823 (1986); *Schlick*, 507 F.2d at 380, and as an analogue of the tort-law concept of "but-for causation" or "causation in fact," *e.g.*, *Chemical Bank* v. *Arthur Anderson & Co.*, 726 F.2d 930, 943 n.23 (2d Cir.) (Friendly, J.), cert. denied, 469 U.S. 884 (1984); *Wilson* v. *Comtech Telecom. Corp.*, 648 F.2d 88, 92 & n.7 (2d Cir. 1981), in the sense that, but for the initial transaction, there would be no injury. Loss causation has been viewed as a synonym for the element of causation generally, *Bastian*, 892 F.2d at 686, and as an analogue of the tort-law concept of "proximate causation" or "legal causation," *e.g.*, *Marbury Mgmt., Inc.* v. *Kohn*, 629 F.2d 705, 708 (2d Cir.), cert. denied, 449 U.S. 1011 (1980), in the sense that the actual loss suffered by the investor must flow from the misrepresentation itself rather than from unrelated circumstances.

To prevail on a Rule 10b-5 claim, a plaintiff must make "a showing of both loss causation * * * and transaction causation." *Wilson* v. *Comtech Telecom. Corp.*, 648 F.2d at 92 n.7 (quoting *Schlick*, 507 F.2d at 380). As the Fifth Circuit put it in one of the most widely cited cases on the subject, "[t]he plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss." *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549 (1981), rev'd in part on other grounds, 459 U.S. 375 (1983). Accord, *e.g.*, *Marbury Mgmt.*, 629 F.2d at 720 (Meskill, J., dissenting) ("the violation must have precipitated the securities decision" and "the victim's injury must also be proven to have derived from that same securities decision"). In other words, it is not enough to allege a misrepresentation and a loss on the sale of the security; the plaintiff must also establish that his loss was caused by the misrepresentation.

The loss-causation requirement "is intended to 'fix a legal limit on a person's responsibility, even for wrongful acts.'" *Castellano* v. *Young & Rubicam, Inc.*, 257 F.3d 171, 187 (2d Cir. 2001) (quoting *First Nationwide Bank* v. *Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994), cert. denied, 513 U.S. 1079 (1995)). Its justification is that a person induced to invest on false pretenses should not be able to recover when the value of the investment declines for reasons unrelated to the misrepresentation—for example, because of a recession. If the law were otherwise, "Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission." *Huddleston*, 640 F.2d at 549. As Judge Posner has explained, "[n]o social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions" to scrutinize offering memoranda "in the hope of uncovering a misrepresentation." *Bastian*, 892 F.2d at 685.

2. *Loss causation is now a statutory element of a Rule 10b-5 cause of action*

As Congress recognized in enacting the PSLRA, meritorious private securities litigation serves a number of beneficial purposes. It enables "defrauded investors [to] recover their losses without having to rely upon government action," it promotes "public and global confidence in our capital markets," and it helps "deter wrongdoing." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995). The PSLRA was prompted by "significant evidence" that these salutary purposes were being "undermined by * * * abusive and meritless suits." *Ibid.* The abusive practices of which Congress heard evidence included "the routine filing of lawsuits against issuers of securities * * * whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only a faint hope that the discovery process might lead eventually to some plausible cause of action." *Ibid.* The legislative history noted that "innocent parties are often forced to pay exorbitant 'settlements'" to terminate such litigation, with the result that "the issuer's own investors * * * are the ultimate losers." *Id.* at 32. The intent of the PSLRA was "to lower the cost of raising capital by combatting these abuses, while maintaining the incentive for bringing meritorious actions." S. Rep. No. 98, 104th Cong., 2d Sess. 4 (1995). Congress sought to effectuate that intent by making a number of substantive and procedural changes to the securities laws.

The legislative history identifies three specific purposes of the PSLRA, and lists the provisions enacted to further each purpose. S. Rep. No. 98, *supra*, at 5-7. First, to "encourage the voluntary disclosure of information by issuers," the PSLRA created a "safe harbor" for forward-looking statements. *Id.* at 5-6. See 15 U.S.C. 77z-2, 78u-5. Second, to "empower investors so that they, not their lawyers, control securities litigation," the PSLRA made a number of changes to class-action procedures. S. Rep. No. 98, *supra*, at 6. See 15 U.S.C. 77z-1(a), 78u-4(a). Third, to "encourage plaintiffs' lawyers to pursue valid claims for securities fraud and to encourage defendants to fight abusive claims," the PSLRA adopted a modified proportionate liability standard, clarified certain of the pleading requirements for securities-fraud complaints, and required courts to make findings concerning compliance with Rule 11 of the Federal Rules of Civil Procedure. S. Rep. No. 98, *supra*, at 6-7. See 15 U.S.C. 77z-1(c), 78u-4(b)(1) and (2), (c), and (f).

The legislative history also identifies other provisions of the PSLRA that were "intended to reduce the cost of raising capital." S. Rep. No. 98, *supra*, at 7. One of them "codif[ied] the requirement under current law 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." *Ibid.* That provision was added to the 1934 Act as Section 21D(b)(4), and is titled "Loss causation." 15 U.S.C. 78u-4(b)(4). It provides that, "[i]n any private action arising under [the 1934 Act], the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate [the 1934 Act] caused the loss for which the plaintiff seeks to recover damages." *Ibid.* Because loss causation is an element of the plaintiff's affirmative case, a complaint must contain allegations that establish the element either directly or inferentially. See 5 Charles A. Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1216, at 156-159 & n.21 (2d ed. 1990). And because loss causation is an element of a fraud cause of action, the allegations must be "stated with particularity," Fed. R. Civ. P. 9(b), and must satisfy the pleading requirements added to the 1934 Act by the PSLRA, see 15 U.S.C. 78u-4(b)(1) and (2).

B. To Establish Loss Causation In A Fraud-On-The-Market Case, A Plaintiff Must Plead And Prove That The Inflation In The Price Of The Security Attributable To The Misrepresentation Was Eliminated Or Reduced

Basic Inc. v. *Levinson* recognizes that reliance is an element of a Rule 10b-5 cause of action, 485 U.S. at 243, but holds that, where the alleged fraud involves a security traded on an open and developed securities market, an investor's "reliance on any public material misrepresentations * * * may be presumed for purposes of a Rule 10b-5 action," *id.* at 247, subject to rebuttal by the defendant, *id.* at 248-249. The premise of the fraud-on-the-market theory is that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations," *id.* at 246, and that "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price," *id.* at 247. The court of appeals held that, in order to establish loss causation in a Rule 10b-5 case alleging fraud on the market, a plaintiff need only "show[] that the price on the date of purchase was inflated because of the misrepresentation." Pet. App. 9a (quoting *Knapp* v. *Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996), cert. denied, 519 U.S. 1112 (1997)). That standard is incorrect. As other courts have held, a plaintiff cannot establish loss causation in a fraud-on-the-market case unless he pleads and proves that he suffered actual injury from the misrepresentation, in that the truth was revealed (at least in part) and the inflation in the price of the security attributable to the misrepresentation was thereby eliminated (or reduced) to the plaintiff's detriment.[1]

1. *The Ninth Circuit's loss-causation standard has been rejected by other courts and is inconsistent with the common law*

a. In *Robbins* v. *Koger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997), the defendant company employed improper accounting practices that overstated its cash flow, with the result that it was able to pay higher dividends, which in turn increased the price of its stock. The company later cut its dividend because of a decrease in available financing, and the stock price dropped as a result. The improper accounting practices were not disclosed until more than a year after the dividend was cut. A class of plaintiffs who had purchased stock between the time cash flow was overstated and the time the dividend was cut sued the company under Rule 10b-5, alleging that they had been misled into purchasing stock by the false statements concerning cash flow in the company's financial statements. A jury returned a verdict for the plaintiffs. *Id.* at 1443-1446.

The Eleventh Circuit reversed, finding the evidence of loss causation insufficient as a matter of law. Assum-

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[1] Loss causation and damages are separate elements. This brief does not address all of the factors that may be relevant to the calculation of damages in a fraud-on-the-market case.

ing without deciding that there was sufficient evidence that the misrepresentation "artificially inflated the price of [the company's] stock," the court held, in acknowledged disagreement with the Ninth Circuit's decision in *Knapp*, that "proof that a plaintiff purchased securities at an artificially inflated price, without more, [does not] satisf[y] the loss causation requirement." *Robbins*, 116 F.3d at 1447-1448. Concluding that there was nothing more in the case before it, the court held that loss causation had not been proved because there was "no evidence that th[e] price inflation was removed from the market price of [the] stock, causing [the] plaintiffs a loss." *Id.* at 1448. Uncontradicted evidence, the court explained, showed that the dividend was cut because the company was concerned that future financing would be unavailable, not because it "discovered [and then disclosed] that past accounting errors had overstated its cash flow." *Ibid.*

In *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000), cert. denied, 531 U.S. 1149 (2001), the defendant company (Cendant) made false statements about its financial condition in connection with a tender offer for shares of another company (ABI), which had the effect of increasing the price of ABI stock. When the misrepresentations were disclosed, the price of ABI stock fell. Shareholders who had purchased ABI stock between the date of the tender offer and the date of the disclosure then filed a class action against Cendant under Rule 10b-5. The district court dismissed the suit, finding (among other things) that the complaint did not adequately plead loss causation. *Id.* at 169-172.

The Third Circuit reversed. Following the Eleventh Circuit's decision in *Robbins*, the court held that, even when a security is purchased "at a price that is inflated due to an alleged misrepresentation," loss causation is established only if the value of the security "actually decline[s] as a result of [the] alleged misrepresentation." *Semerenko*, 223 F.3d at 184-185. The court determined that the complaint met that standard, because it alleged that the class "purchased shares of ABI common stock at a price that was inflated due to the alleged misrepresentations" *and* that it "suffered a loss when the truth was made known and the price of ABI common stock returned to its true value." *Id.* at 185.

The "loss causation" standard applied by the Third and Eleventh Circuits in these Rule 10b-5 cases is identical to the "legal causation" standard set forth in the Second Restatement of Torts for common law fraud in the sale of securities. In the portion of the Restatement that covers the tort of fraudulent misrepresentation, in the commentary to the section titled "Legal Causation of Pecuniary Loss," the Restatement says that

> one who misrepresents the financial condition of a corporation in order to sell its stock will become liable to a purchaser who relies upon the misinformation for the loss that he sustains *when the facts as to the finances of the corporation become generally known and as a result the value of the shares is depreciated on the market.*

Restatement of Torts § 548A cmt. b (emphasis added). The Restatement contrasts this situation with one in which "the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition." *Ibid.* In a circumstance of that type—one, for example, in which the value of the stock goes down "because of the sudden death of the corporation's leading officers"—there is "no liability." *Ibid.* See also

W. Page Keeton et al., *Prosser and Keeton on the Law of Torts* § 110, at 767 (5th ed. 1984) (*Prosser and Keeton on Torts*) ("[I]f false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors [that] in no way relate to the representation[,] will not afford any basis for recovery."). As the Restatement explains, "[a]lthough the misrepresentation [in such a case] has in fact caused the loss," in the sense that "it has induced the purchase without which the loss would not have occurred," the misrepresentation "is not a legal cause of the loss for which the maker is responsible." Restatement of Torts § 548A cmt. b.[2]

b. The typical case in which the truth is revealed and the inflation attributable to a misrepresentation is removed from the price of stock is one in which the company makes a corrective disclosure—through a press release, for example, or a public filing—that is followed by a drop in the price. *Semerenko* is such a case. But the fraud can be revealed by means other than a corrective disclosure, and a drop in the stock price may not be a necessary condition for establishing loss causation in every fraud on-the-market case. To the extent that courts or litigants have suggested otherwise, they are mistaken.

First, inflation attributable to a misrepresentation might be reduced or eliminated even if there were a net *increase* in price. That could happen if the company

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[2] In cases decided both before and after the enactment of the PSLRA, the Second Circuit has relied on this section of the Restatement in describing the loss-causation element of a Rule 10b-5 cause of action. See *AUSA Life Ins. Co.* v. *Ernst & Young*, 206 F.3d 202, 219-220 (2000); *Citibank, N.A.* v. *K-H Corp.*, 968 F.2d 1489, 1496 (1992); *Marbury Mgmt.*, 629 F.2d at 708.

corrected the false information and at the same time issued unrelated positive information. Thus, while it is ordinarily a decline in the price of stock that harms investors, they can also suffer injury "[i]f a stock does not appreciate as it would have absent the fraudulent conduct," *Gebhardt* v. *ConAgra Foods, Inc.*, 335 F.3d 824, 831-832 (8th Cir. 2003), so that their profit is smaller than it would otherwise have been. As Judge Easterbrook has observed, "a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counter-balancing the loss." *Goldberg* v. *Household Bank*, 890 F.2d 965, 966 (7th Cir. 1989).

Second, the inflation in the price of a security attributable to a misrepresentation might be reduced or eliminated even if the company does not make a public statement that discloses the true state of affairs. The truth can be revealed by events rather than words. If, for example, the misrepresentation is that the financial condition of the company is such that it would be immune from a particular downturn in the economy, and if there is then such a downturn and the company is affected, those events will reveal to the public that the representation was untrue. See Restatement of Torts § 548A cmt. b. A number of court of appeals decisions recognize that loss causation can be established in circumstances of this type (although they are not fraud-on-the-market cases). See, *e.g.*, *Emergent Capital Inv. Mgmt., LLC* v. *Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003) (defendants "concealed [facts that] reflected [an] executive's inability to manage debt and maintain adequate liquidity," and plaintiffs' investment "became worthless because of the company's liquidity crisis," which plaintiffs attributed to "the executive's inability to manage the company's finances"); *Bastian*, 892 F.2d at 685 ("a broker gives false assurances to his customer that an investment is risk-free," but "[i]n fact it is risky, the risk materializes, [and] the investment is lost"). Cf. *Prosser and Keeton on Torts* § 110, at 767 ("the plaintiff stores his goods in a warehouse represented * * * to be fireproof and they are destroyed when it burns down").

2. *The Ninth Circuit's loss-causation standard is incorrect*

a. The Ninth Circuit does not require a plaintiff in a fraud-on-the-market case to plead or prove that he suffered actual injury from the misrepresentation, in that the inflation in the price of the security attributable to the defendant's misrepresentation was eliminated or reduced when the truth was revealed. Under its view of loss causation, an investor's loss "occurs at the time of the transaction," when he is harmed by paying too much, and a causal connection exists because it is the misrepresentation that inflated the price. Pet. App. 9a. That view is mistaken. "[A] purchase-time value disparity, standing alone, cannot satisfy the loss causation pleading requirement." *Emergent Capital*, 343 F.3d at 198.

A necessary corollary of the fraud-on-the-market theory is that the inflation associated with an alleged misrepresentation will be incorporated into the value of a security, not only at the time of purchase, but until the truth is disclosed. See *Semerenko*, 223 F.3d at 185. An investor will therefore be able to recoup his "overpayment" by reselling the security at the inflated price before the misrepresentation is corrected. See *ibid.* For that reason, it cannot be said that a plaintiff in a fraud-on-the-market case who purchases a security at an inflated price has suffered *any* loss at the time of purchase, much less one caused by the defendant's misrepresentation. See *ibid.*; *Robbins*, 116 F.3d at 1448. And even if the security's price declines after the purchase for reasons unrelated to the fraud, the investor has still suffered no loss *caused by the fraud* and thus has no right to recovery. See *Huddleston*, 640 F.2d at 549 n.25.

It might be argued that the possibility of recoupment does not alter the fact that an investor who pays too much for a security suffers a loss by virtue of the overpayment. Such an argument would be without merit. "Loss" means a decline in value of the security, and in a fraud-in-the-market case, that necessarily occurs at some point *after* the security has been purchased.

Determining loss at the time of purchase would grant a windfall to investors who sold before the reduction or elimination of the artificial inflation, because they would recover the portion of the purchase price attributable to the fraud on resale, and then, under the Ninth Circuit's logic, would be entitled to recover that same amount again as damages for the loss. If, on the other hand, damages would not be recoverable in such a case, as respondents contend (Supp. Br. 1-3), the Ninth Circuit's standard would lead to the bizarre result that a plaintiff could establish both loss and loss causation but be categorically disentitled to any damages for the loss. Respondents' concession that there could be no recovery is necessitated by the reality that a plaintiff in such a case has suffered no injury from the "overpayment," because, by virtue of the resale before the value of the security is corrected, the overpayment remains only theoretical. The possibility of resale without injury underscores that loss causation occurs when the inflated value of the security is corrected, not at the moment of purchase.

Adopting the Ninth Circuit's standard would also mean that loss causation is present in every fraud-on-the-market case in which the presumption of reliance is unrebutted. That is because, under the Ninth Circuit's view, loss causation is satisfied when the misrepresentation increased the purchase price, and the fraud-on-the-market theory itself provides the causal connection between the price of a security and a material misrepresentation. A fundamental premise of the fraud-on-the-market theory is that a material misrepresentation "typically affects the price of the stock," *Peil* v. *Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986) (quoted in *Basic Inc.*, 485 U.S. at 244), and the theory therefore presumes a connection not only between the misrepresentation and the investor's "decision to trade," but also between the misrepresentation and "the price * * * paid" for the security, *Basic Inc.*, 485 U.S. at 248. It would make little sense for Congress to have imposed on plaintiffs the "burden of proving" that the misrepresentation "caused the loss," 15 U.S.C. 78u-4(b)(4), if such causation were necessarily present in every fraud-on-the-market case in which reliance is established. And since the abusive lawsuits that prompted enactment of the PSLRA were typically class actions, a type of suit that invokes the fraud-on-the-market theory, it is not likely that Congress had in mind cases involving "face-to-face transactions," *Basic Inc.*, 485 U.S. at 243-244, when it codified the loss-causation requirement.

In this respect, the Ninth Circuit's standard renders loss causation effectively indistinguishable from transaction causation, as both the Second Circuit and the Eleventh Circuit have observed, see *Emergent Capital*, 343 F.3d at 198; *Robbins*, 116 F.3d at 1448, because, in the Ninth Circuit, proof that the plaintiff purchased stock in a well-developed market after the defendant made a material misrepresentation will establish the two elements simultaneously (assuming the presumption of reliance is unrebutted). Such a result is difficult to reconcile with the well-established principle that "[l]oss causation is a separate element from transaction causation." *AUSA Life Ins. Co.* v. *Ernst & Young*, 206 F.3d 202, 216 (2d Cir. 2000). Accord, *e.g.*, *Huddleston*, 640 F.2d at 549 n.24; *Schlick*, 507 F.2d at 380.

More fundamentally, the decision below is difficult to reconcile with the very *idea* of loss causation, which is that a plaintiff has no right to recover merely because he purchased a security on false pretenses. Suppose, for example, that an investor bought stock in a company that falsely claimed to be insured; the company acquired insurance a week later, before any of its assets were damaged (*i.e.*, before the misrepresented risk materialized); the company performed well, causing the price of its stock to increase; and the investor then sold the stock at a profit. Under the Ninth Circuit's standard, the investor would be able to demonstrate loss causation. Under the correct standard, there would be no loss at all, much less loss that could be attributed to the misrepresentation.

b. In addition to placing a loss-causation provision in the 1934 Act, the PSLRA placed one in Section 12 of the 1933 Act, 15 U.S.C. 77*l*(b). Beyond the flaws already identified, interpreting the provision in the 1934 Act as the Ninth Circuit does is difficult to reconcile with the language in the 1933 Act.

While the 1934 Act codifies the rule that loss causation is an element that the plaintiff must establish in order to recover on his claim, Section 12 of the 1933 Act makes the *absence* of loss causation an affirmative defense that can limit or preclude a plaintiff's recovery. Subsection (a)(2) of Section 12 prohibits certain misrepresentations "by means of a prospectus or oral communication." 15 U.S.C. 77*l*(a)(2). Subsection (b), like the provision in the 1934 Act, is titled "Loss causation." 15 U.S.C. 77*l*(b). It provides that, if the defendant proves that the amount recoverable under subsection (a)(2), or a portion of it, "represents other than the depreciation in value of the subject security resulting from [the misrepresentation] in the prospectus or oral communication" at issue, then that amount, or portion of it, "shall not be recoverable." *Ibid.*

There is no reason to suppose that, in enacting the PSLRA, Congress intended that (apart from the burden of proof) the concept of loss causation would have different meanings in the 1933 Act and the 1934 Act.[3] It is therefore reasonable to conclude that, in the loss-causation provision the PSLRA added to the 1934 Act, Congress intended the general requirement that the

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[3] The PSLRA's legislative history notes that some courts had held that a plaintiff suing under Section 12 "need not prove that the misstatement or omission caused the loss." S. Rep. No. 98, *supra*, at 23. Congress was concerned that that interpretation "put [issuers] in the position of insuring shareholders and purchasers against normal market risk" and "provide[d] an unfair windfall to shareholders who ha[d] not in any way been harmed by the misstatement or omission." *Ibid.* For example, a plaintiff would be able to recover under that interpretation of Section 12 if a company "fail[ed] to state in a public offering prospectus that it conducts business in a foreign country," the company's "foreign business [was] highly profitable," but its "overall profits decline[d] as the result of unrelated factors (such as a downturn in its domestic business)." *Ibid.* Congress therefore amended Section 12 to "clarify that defendants may raise the absence of 'loss causation' as an affirmative defense." *Ibid.* The loss-causation provision "is modeled after Section 11 of the Securities Act [of 1933], which provides for a similar affirmative defense," *ibid.*, and contains essentially identical language, see 15 U.S.C. 77k(e).

misrepresentation "caused the loss for which the plaintiff seeks to recover damages," 15 U.S.C. 78u-4(b)(4), to mean that a plaintiff must plead and prove the converse of what the defendant must prove under the 1933 Act—namely, that the plaintiff was injured by a "depreciation in value of the subject security resulting from" the misrepresentation at issue. Since the value of a security obviously has not depreciated at the time of purchase, this requirement is not consistent with the Ninth Circuit's standard, under which loss causation can be established at that time. See Pet. App. 9a. Instead, requiring a "depreciation in value of [a] security resulting from" a misrepresentation appears to be another way of saying that the inflation attributable to the misrepresentation must have been eliminated or reduced.

c. Though it was not relied upon by the court below, there is arguably some support for the Ninth Circuit's standard in the legislative history of the PSLRA. The section of the Conference Report that discusses the applicable loss-causation provision reads, in its entirety, as follows:

> The Conference Committee also requires the plaintiff to plead and then to prove that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff in new Section 21D(b)(4) of the 1934 Act. For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.

H.R. Conf. Rep. No. 369, *supra*, at 41. The Senate Report contains similar language:

> The Committee also requires the plaintiff to show that the misstatement or loss alleged in the com-

> plaint caused the loss incurred by the plaintiff. For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.

S. Rep. No. 98, *supra*, at 15.

The "example" provided in the Reports, if construed to be an exhaustive description of the plaintiff's burden even in the fraud-on-the-market context, would be essentially identical to the Ninth Circuit's standard. But these brief passages in the Reports do not elaborate on the "example" they provide or explain whether additional proof would be required. For these reasons, and because of the defects in the Ninth Circuit's standard identified above, it is not likely that this isolated, unelaborated example in the Committee Reports reflects a considered congressional judgment as to the standard for establishing loss causation in a Rule 10b-5 case. A contrary conclusion would be particularly unwarranted in light of the statement in a different portion of the same Senate Report that the loss-causation provision of the 1934 Act "codif[ies] the requirement under current law 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." S. Rep. No. 98, *supra*, at 7. That language cannot be reconciled with the Ninth Circuit's approach, because, under the latter, a plaintiff who purchased stock at a price inflated by a misrepresentation can establish loss causation even if the subsequent loss in value was caused by factors unrelated to the misrepresentation—and, indeed, even if there was no loss in value at all.

C. The Complaint Does Not Allege That The Inflation In The Price Of Dura Stock Attributable To The Alleged Misrepresentations About Albuterol Spiros Was Eliminated Or Reduced

The loss-causation allegation in the complaint is that respondents "were damaged" because, "[i]n reliance on the integrity of the market, they paid artificially inflated prices for Dura securities." Resp. C.A. E.R. Tab 72, at 85 (¶ 179). This allegation may satisfy the Ninth Circuit's standard, see Resp. C.A. Br. 18 (arguing that it does); Mem. of Points and Authorities in Opp. to Mot. to Dismiss 40 (same), but, for the reasons set forth above, that standard is erroneous. And respondents' loss-causation allegation does not satisfy the correct standard, which requires that respondents allege actual injury from the misrepresentations, in that the inflation in the price of Dura stock attributable to the alleged misstatements concerning Albuterol Spiros was eliminated or reduced when the truth was revealed (by, for example, a disclosure correcting the misstatements).

Nor do respondents allege elsewhere in the complaint that the inflation was removed. Insofar as the complaint says anything about a corrective disclosure followed by a decline in the stock price, for example, the allegations relate to the announcement about Ceclor CD in early 1998, see Resp. C.A. E.R. Tab 72, at 17 (¶ 32), 61-62 (¶ 134), not to the one about Albuterol Spiros several months later. At the time of the former disclosure, the true facts concerning Albuterol Spiros were still unknown to the public, and the price of Dura stock was still artificially inflated (according to respondents' theory) due to the earlier announcements about the device.

The district court was therefore correct in holding that respondents' allegations concerning Albuterol

Spiros do not state a claim for relief under Rule 10b-5. Whether respondents can amend the complaint to satisfy the correct loss-causation standard, and, if they can, whether they should be permitted to do so, are questions to be addressed on remand in the event that they seek leave to amend for that purpose.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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