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Dura's Unresolved Questions: Must Plaintiff's Plead with Particularity and Identify a Corrective Disclosure?

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INTRODUCTION

In *Dura Pharmaceuticals, Inc. v. Broudo*,[1] the Supreme Court held that Section 10(b) of the Securities Exchange Act of 1934 permits plaintiffs to recover damages based on a stock drop only where the fraud "proximately caused the plaintiff's economic loss." The *Dura* decision, which has already been cited in more than 200 decisions by lower courts, undoubtedly benefits defendants and their insurers by requiring plaintiffs to plead loss causation with more rigor.

At the same time, however, *Dura* left unresolved important issues that will ultimately impact the extent to which the decision benefits defendants. First, the Supreme Court did not decide whether plaintiffs must plead loss causation with particularity. Second, the Court did not expressly address whether plaintiffs must plead a corrective disclosure or whether plaintiffs can instead sufficiently allege loss causation by pleading that inflation was dissipated in some other way.

This article discusses how lower courts have begun to address these unresolved issues that follow from *Dura*. Plaintiffs have, not surprisingly, argued that *Dura* requires very little so that they can survive the motion to dismiss – and presumably extract potentially large settlements – even though they would not ultimately be able to survive a motion for summary judgment because of difficulties in establishing loss causation. Fortunately, many lower courts have rejected these efforts and required plaintiffs to plead loss causation with particularity and to identify a corrective disclosure.

These issues are critical to carriers for at least two reasons. First, they impact the likelihood that the complaint will survive the motion to dismiss. Second, even if the case continues, these issues foreshadow how rigorously the court may approach loss causation at later stages of the case, such as class certification and summary judgment.

MUST PLAINTIFFS PLEAD LOSS CAUSATION WITH PARTICULARITY?

Justice Breyer's decision in *Dura* notes that Federal Rule of Civil Procedure 8(a)(2) requires only "a short and plain statement of the claim showing that the pleader is entitled to relief." The Court then states that "we assume, **at least for argument's sake**, that neither the Rules nor the securities statutes impose any special further requirements in respect to the pleading of proximate causation or economic loss."[2] This statement leaves open the question whether plaintiffs must meet a heightened pleading standard for loss causation.

Courts have taken three different approaches with respect to the pleading requirement. Some have adopted the standard favored by plaintiffs and concluded, based on Justice Breyer's reference to Federal Rule Civil Procedure 8(a)(2), that *Dura* "did not create a heightened pleading standard."[3] Under this approach, which has gained the most traction in the Ninth Circuit, plaintiffs may need only to provide "some indication that the drop in [the company's] stock price was causally related to [the company's] financial misstatements."[4]

Other courts, however, have concluded that *Dura* did not decide the proper pleading standard for loss causation. As one court explained, "[b]ecause the scant allegations in *Dura* failed to satisfy even 'simple' notice pleading requirements, the Supreme Court expressly declined to consider whether loss causation must be pled with particularity."[5] In a decision in early 2006, a district court in North Carolina held that the Supreme Court had not decided the issue and that plaintiffs must plead fraud with particularity under Federal Rule of Civil Procedure 9(b).[6] The district court noted that, although the Fourth Circuit had not addressed the pleading standard for loss causation, the Third and Fifth Circuits had held, in cases decided prior to *Dura*, that loss causation must be pled with particularity. The district court also reasoned that the Fourth Circuit had held that common law fraud must be pled with particularity, and the Supreme Court had relied on common law fraud as the foundation for its holding in *Dura*. The district court therefore concluded that plaintiffs had failed to satisfy the pleading standard in a case alleging misrepresentations in connection with a failed merger, because the stock drops preceded the company's announcement that it was writing off the acquisition.

Even without requiring the complaint to comply with the pleading requirements of Federal Rule of Civil Procedure 9(b), other courts have held that there must be at least some rigor to the complaint's allegations as to loss causation. For example, the Sixth Circuit considered a complaint that, with respect to loss causation, alleged only that "[a]s a direct and proximate result of defendants' wrongful conduct," plaintiffs suffered damages.[7] The court held that such a pleading was inadequate because otherwise "the mere inclusion of boilerplate language would suffice everywhere and would defeat the requirement that a plaintiff explain how the loss occurred."[8] The court reasoned that plaintiffs had failed to: (1) plead that the alleged fraud became known to the market on any particular day, (2) estimate the damages that the alleged fraud caused, or (3) "connect the alleged fraud with the ultimate disclosure and loss."[9]

A district court in Michigan took a similar approach in a case alleging that the officers and directors of a company concealed from investors a serious problem with the company's most important customer.[10] The court noted that the complaint contained detailed allegations of the allegedly false and misleading statements as well as the losses plaintiffs suffered following an unfavorable earnings announcement. The court nevertheless dismissed the complaint because "[w]holly absent from its pleadings, however, is a nexus between the misrepresentations of which [plaintiff] complains and the losses they suffered."[11] Although the complaint alleged that the investor losses were "a direct and proximate result" of the unlawful conduct, the district court stated that "[p]laintiffs must do more than use talismanic language to cure an otherwise inadequately pled complaint."[12]

MUST PLAINTIFFS PLEAD A CORRECTIVE DISCLOSURE?

Less than a month after the Supreme Court decided *Dura*, the Southern District of New York held that plaintiffs must identify a corrective disclosure in the complaint in order to meet their burden on loss causation. In *In re Initial Public Offerings Securities Litigation,*[13] the court considered a motion to dismiss a class action complaint alleging that various defendant banks had artificially depressed earning of companies prior to initial public offerings ("IPOs") in order to create a spike in share price following the IPOs. Relying on Second Circuit decisions prior to *Dura*, the court rejected plaintiffs' argument that they satisfied the standard by alleging a negative impact on stock price when defendants could not continue the trend. The court explained that "a failure to meet earning forecasts has a *negative* effect on stock prices, but not a *corrective* effect."[14] According to the decision, "a court cannot presume dissipation of the inflationary effect; a plaintiff must explicitly allege a disclosure or some other corrective event."[15] The court explained the importance of requiring plaintiff to do more than plead a stock drop:

> If downturns in stock prices based on such mundane events as failures to meet forecasts and downward revisions of forecasts were legally sufficient to constitute disclosures of securities fraud, then any investor who loses money in the stock market could sue to recover for those losses without alleging that a fraudulent scheme was ever disclosed and that the disclosure caused their losses. That would effectively convert the securities laws into an insurance policy for investors.[16]

The district court noted that a corrective disclosure could occur in a newspaper article bringing to light the alleged fraud. But in the case at hand, it reasoned that plaintiffs' only allegation of such a disclosure was a single newspaper article suggesting a general market practice of giving "low-ball figures" to analysts. Since the article did not specifically mention any bank or indicate that the banks had deliberately engaged in the practice, the court concluded that the article was not a corrective disclosure. The Southern District of New York's decision in *In re eSpeed, Inc. Securities Litigation,*[17] provides a good example of what, at least in the Second Circuit, plaintiffs must allege in terms of corrective disclosure. The case involved a company that operated electronic marketplaces for bonds and other securities. Plaintiffs alleged that defendants made misrepresentations by describing a new trading technology in a falsely positive light. At the end of the class period, defendants provided an update of the company's financial expectations. The press release made no mention of problems with the new technology. But the company, citing competitive pricing pressure and lower than expected volume in Europe, disclosed disappointing expectations for the next quarter. On an analyst call the same day, an analyst asked if difficulties with the new technology were the source of the problems, but the CEO denied that this was the case. The stock price dropped 25% the next day.

The court held that the allegation of a stock drop combined with the analyst question was a "conclusory assertion" that "without more, cannot substitute for specific allegations that disclosure regarding [the technology] was a proximate cause of the economic loss."[18] However, the court also noted that plaintiffs had pointed to a *CBS Markewatch* article concerning the earnings announcement, which noted for the first time to the market that fees and charges associated with the new technology could be damaging the company's market share. The court reasoned that plaintiffs' reference to that article sufficed for pleading loss causation, because the article provided sufficient indication of the causal connection that plaintiffs alleged.

A number of courts from other jurisdictions appear to be taking a similarly strict approach. For example, in *In re Compuware Securities Litigation,*[19] plaintiffs sued a company that provided computer consulting services, alleging that it failed to disclose problems in its relationship with its principal customer. Plaintiffs alleged that they had pled loss causation sufficiently by alleging that on the last day of the class period, the company revealed in a press release that a revenue shortfall would require it to take restructuring and goodwill impairment charges, which sent the stock price plummeting downward. The court rejected plaintiffs' position, reasoning that the press release was not a corrective disclosure because it made no mention of problems with customers. The court explained that, as a result, it could not determine what portion, if any, of the stock drop could be attributed to the alleged fraud.[20]

Courts in the Ninth Circuit, however, have held that a plaintiff can sufficiently plead loss causation by alleging stock drop following disclosure of a company's "true financial condition," even in the absence of a corrective disclosure.[21] In *In re Daou Systems, Inc*., the Ninth Circuit considered loss causation in a securities class action alleging that defendants had inflated revenue by recognizing revenue prematurely. The district court had dismissed the complaint based on loss causation after defendants pointed out that the stock drop preceded the disclosure of the practices at issue on the litigation. The Ninth Circuit reversed, reasoning that the stock price "fell precipitously after defendants began to reveal figures showing, the company's true financial condition."[22] The court did cabin its holding, however, by noting that the company's stock had dropped substantially even before disclosure of the financial difficulties and concluding that loss causation had not been pled sufficiently with respect to that incremental drop prior to announcement of the company's financial condition.

In *Plumbers and Pipefitters Local 572 Pension Fund v. Cisco Systems, Inc.*,[23] the court noted the tension between *Daou* and *IPO Securities Litigation*. The plaintiffs alleged that the company and its top officers and directors made misrepresentations about the company's accounting, financial results and business. Relying on *IPO Securities Litigation*, defendants argued that the complaint did not adequately plead loss causation with respect to the stock drop following an announcement of some financial issues, because there was no corrective disclosure with respect to the fraudulent practices at issue in the complaint. The district court disagreed. It reasoned that plaintiffs need only to provide "some indication" of loss causation. Although there was no corrective disclosure, the court held that loss causation was pled sufficiently based on the allegation that the financial disclosures at the end of the class period disclosed the "truth" about the company's financial condition.

This approach differs from that taken by courts in the Second Circuit and other jurisdictions, because it allows plaintiffs potentially to plead loss causation based on a stock drop alone. The problem with doing so is that, as the Southern District of New York recognized in *IPO Securities Litigation*, it can allow plaintiffs to rely on stock drop as the basis for loss causation in a securities case.

In *Dura*, Justice Breyer noted that one of the reasons for requiring plaintiffs to plead loss causation is that when an investor sells stock at a loss, "that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price."[24] Yet without requiring a more specific allegation as to loss causation, defendants cannot understand how plaintiffs contend the alleged fraud caused the stock drop.

CONCLUSION

To date, despite the large number of post-*Dura* cases addressing loss causation, the meaning and impact of the decisions remains uncertain. No doubt, the decision benefits the defense bar and insurance industry by, at a minimum, rejecting the Ninth Circuit's prior holdings that plaintiffs need only allege inflation in the stock price, without more. In addition, *Dura* reinforces that loss causation remains a central element of any Section 10(b) claim.

But the benefit of *Dura* varies from court to court. In a best-case jurisdiction, plaintiffs will need to plead loss causation with particularity and to link a corrective disclosure to the stock drop. But, at least in the Ninth Circuit, a plaintiff may be able to get away with briefer, more generalized allegations that do not rely on a corrective disclosure.

Although some of the critical issues and differing approaches to loss causation are emerging, the issue has not fully played out. Most of the cases to date have been decided by districts courts. As these issues work their way up to the courts of appeals, further guidance and clarity may result. In addition, the decisions to date have generally been at the motion-to-dismiss stage. Over time, courts will also confront these issues on motions for class certification and summary judgment. Even those courts that have been relatively lax at the earlier stage may, particularly in light of *Dura*, impose more rigor at later points in the case.

The Supreme Court likely has not spoken for the last time on these issues given the disagreements about what *Dura* means. But until it does, defense counsel and carriers need to track the evaluation and variation in approaches to loss causation in the post-*Dura* world. These issues will prove important to deciding when to try to settle cases, to assessing the impact of court rulings on loss causation and, ultimately, to valuing securities cases.

FOOTNOTES

1 544 U.S. 336, 346 (2005).
2 *Id.* at 346.
3 *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Systems, Inc.*, 411 F. Supp. 2d 1172, 1175 (N.D. Cal. 2005); *see also In re Sara Lee Corp. Sec. Litig.*, 2006 WL 1980199, at *7 (N.D. Ill. July 10, 2006) ("Plaintiffs, though, need not meet a heightened pleading standard in making this causal allegation.").
4 *In re Daou Systems, Inc.*, 411 F.3d 1006, 1026 (9th Cir. 2005).
5 *In re: The First Union Corp. Sec. Litig.*, 2006 WL 163616 at *6 (W.D.N.C. Jan. 20, 2006); *see also In re eSpeed, Inc. Sec. Litig.*, 2006 WL 880045 at *7 (S.D.N.Y. Apr. 3, 2006) (pleading standard for loss causation "is an issue left open by *Dura* and not squarely addressed by the Second Circuit").
6 *First Union Sec. Litig.*, 2006 WL 163616.
7 *D.E. & J. Ltd. Partnership v. Conaway*, 133 Fed. Appx. 994, 1000 (6th Cir. 2005).
8 *Id.* at 1000.
9 *Id.*
10 *In re Compuware Sec. Lit.*, 386 F. Supp. 2d 913, 918 (E.D. Mich. 2005).
11 *Id.* at 918.
12 *Id.*
13 399 F. Supp. 2d 261 (S.D.N.Y. 2005).
14 *Id.* at 266.
15 Id. at 266. *See also In re Initial Public Offering Sec. Litig.*, 399 F. Supp.2d 298, 308 (S.D.N.Y. 2005) (denying motion for reconsideration of same and stating that "plaintiffs' failure to allege a corrective disclosure of the falsity of defendants' opinions precludes any claim that such falsity caused their losses.").
16 399 F. Supp. 2d at 266-267.
17 2006 WL 880045 (S.D.N.Y. 2006).
18 *Id.* at * 18
19 386 F. Supp. 2d 913 (E.D. Mich. 2005).
20 *See also Schlescher v. Wendt*, 2005 WL 1656871 at *4 (S.D. Ind. 2005) (dismissing complaint based on loss causation and noting that "the most important point here is that the truth about matters that plaintiffs allege were concealed or misrepresented did not come out publicly until months after the end of the class period"); *D.E. & J. Lt'd Partnership v. Conaway*, 133 Fed. Appx. 994 (6th Cir. 2005) (stock drop following bankruptcy insufficient because it does not establish that fraud caused the bankruptcy or loss).
21 411 F.3d 1006, 1026 (9th Cir. 2005).
22 *Id.* 1026.
23 411 F. Supp. 2d 1172 (N.D. Cal. 2005).
24 544 U.S. at 343.

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