wiley

NEWSLETTER

U.S. Supreme Court Rejects the Price Inflation Approach to Pleading and Proving Loss Causation in Its Decision in *Dura Pharmaceuticals*

April 2005

On April 19, 2005, the U.S. Supreme Court issued its much-anticipated decision regarding the pleading and proving of loss causation in securities fraud cases. In a unanimous decision authored by Justice Breyer, the Court rejected the Price Inflation Approach followed by the Ninth Circuit, which allows plaintiffs to plead and establish loss causation simply by alleging and proving that they purchased a security at a price that was artificially inflated by misrepresentations or omissions. *Dura Pharmaceuticals, Inc. v. Broudo*, No. 03-932 (U.S. April 19, 2005).

U.S. Supreme Court's Decision

The Supreme Court rejected the Price Inflation Approach for proving loss causation on three grounds. First, the Court reasoned that the purchase of a share of stock at an inflated price does not in and of itself constitute a loss: "[A]s a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value." The Court concluded that "[g]iven the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will *sometimes* play a role in bringing about a future loss."

Second, the Court noted that the Price Inflation Approach lacks support in precedent. The Court observed that judicially implied private securities-fraud actions resemble common-law deceit and misrepresentation actions, and that the common law has insisted that

Authors

Kimberly M. Melvin
Partner
202.719.7403
kmelvin@wiley.law

plaintiffs bringing such actions show that they suffered actual economic loss. Given these common law requirements, the Court stated that it did not find it surprising that the Courts of Appeals for the Second, Third and Eleventh Circuits had rejected the Price Inflation Approach to proving loss causation.

Finally, the Court faulted the Price Inflation Approach for overlooking the important securities law objective of protecting investors against losses that misrepresentations actually cause, rather than providing broad insurance against market losses. The Court noted that the Private Securities Litigation Reform Act of 1995 imposes on plaintiffs "the burden of proving" that a defendant's misrepresentations "caused the loss for which the plaintiff seeks to recover," 15 U.S.C. §78u-4(b)(4), and that the Price Inflation Approach, in contrast, "would allow recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss."

In light of its holding concerning the need for plaintiffs to prove proximate causation and economic loss, the Court also held that plaintiffs had failed adequately to allege those elements. The Court recognized that pleading rules are not meant to impose a great burden upon plaintiffs but stated that "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 has in mind." The Court added that forgoing such a requirement "would tend to transform a private securities action into a partial downside insurance policy."

Key Impacts

- The U.S. Supreme Court's decision resolves the Circuit split concerning the requirement for pleading and proving loss causation in securities fraud suits. Plaintiffs bringing suit in the Eighth and Ninth Circuits will no longer be able to plead and prove loss causation solely by alleging and establishing the purchase of a security at an artificially inflated price. Rather, plaintiffs must allege and prove that they suffered an actual economic loss that was proximately caused by misrepresentations or omissions.
- While the Court held that plaintiffs must allege and demonstrate that defendants' misrepresentations proximately caused an economic loss, the Court did not provide a great deal of guidance about the standard for satisfying these requirements, which will likely be the subject of future litigation. As an example, the Court's opinion appears to hold open the possibility that plaintiffs can satisfy these requirements by pleading and proving that, upon a company's disclosure of both good news and information that corrects prior misrepresentations, the increase in the price of their securities was less than it would have been in the absence of the misrepresentations and the subsequent corrective disclosure.
- Statements by the Court regarding the "tangle of factors affecting price" of a security, such as "changed economic circumstances, changed investor expectations [and] new industry-specific or firm-specific facts" will likely further efforts by defendants to focus on these factors during general discovery, expert discovery and trial, and give defendants and their insurers additional ammunition with which to attack plaintiffs'-style damages figures during settlement negotiations.