

BAILEY CAVALIERI LLC

ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422
telephone 614.221.3155 facsimile 614.221.0479
www.baileycavalieri.com

Dura Pharmaceuticals: Linking Fraud and Damages

On April 19, 2005, the United States Supreme Court issued an important decision which should eliminate certain types of securities class action lawsuits and which should reduce recoverable damages in most of the remaining securities class action lawsuits. In *Dura Pharmaceuticals, Inc. v. Broudo*, the Court held that plaintiffs in a securities fraud case must prove a causal connection between the alleged misrepresentations and a subsequent stock drop. In so holding, the Court rejected plaintiffs' "price inflation" theory which would require plaintiffs simply to prove the stock price at the time of the plaintiffs' purchase was inflated, regardless whether there was a subsequent stock drop attributable to a corrective disclosure of the misrepresented information. The unanimous decision should be helpful for defendants in securities class action lawsuits and their insurers, although the Court left for further debate several important issues.

A. Background

In the *Dura Pharmaceuticals* case, the plaintiffs alleged that the Company falsely claimed that it expected FDA approval for a new asthmatic spray device. Later, the Company announced that its earnings would be lower than expected (for reasons unrelated to the asthmatic spray device), resulting in the Company's stock price dropping by approximately 50%. Eight months later, the Company announced that the FDA would not approve the new asthmatic spray device. In response, the stock price dropped briefly but recovered nearly all of its value within a week. The plaintiffs alleged that the Company and the defendant officers misrepresented material facts regarding the likelihood that the FDA would approve the new asthmatic spray device, thereby causing the Company's share price to be artificially inflated during the class period, which ended when the Company's stock price dropped 50% following its revised earnings report.

Courts have long recognized that one of the elements of a private cause of action for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 is "loss causation," which requires the plaintiff to prove a causal connection between the material misrepresentation and the loss. Because the stock drop at the end of the class period in the *Dura Pharmaceuticals* case was not directly attributable to the alleged misrepresentations regarding FDA approval, plaintiffs argued that the necessary loss causation existed because shareholders who purchased Company stock during the class period were harmed since they purchased the shares at an artificially inflated price. This theory of loss causation is frequently referred to as the "price inflation" theory.

B. Price Inflation Theory Rejected

The Supreme Court rejected plaintiffs' price inflation theory to prove loss causation for several reasons. First, the Court found that "as a matter of pure logic" the plaintiff does not suffer loss at the moment the plaintiff purchases shares at an artificially inflated price. The instant following the purchase, the market price for the shares remains at the artificially inflated level, and thus the plaintiff can sell the shares for no loss.

Second, the Court observed that it is not inevitable that an initially inflated purchase price will lead to a later loss. When the shares are subsequently sold, even at a lower price following a corrective disclosure, that lower price may reflect a variety of other factors, such as "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." According to the Court, other things being equal, the longer the time between the purchase and sale of the securities, the more likely that other factors will cause the stock drop and resulting loss to plaintiffs. Therefore, simply because the share price may have been inflated on the date it was purchased, plaintiffs do not necessarily suffer loss as a result of that price inflation.

Third, the Court found no support in prior case law for the price inflation theory. The Court noted that the private securities fraud action has its roots in the common law actions for deceit and misrepresentation, which impose liability for pecuniary loss caused by the deceit or misrepresentation. Given this heritage, the Court concluded that the price inflation theory failed to establish a causal connection between the misrepresentation and the loss.

Interestingly, the Court noted that the price inflation theory of loss causation was arguably inconsistent with the objectives of the securities statutes, including the Private Securities Litigation Reform Act of 1995 ("PSLRA"). According to the Court, private securities fraud litigation is not available "to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." The PSLRA "makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss."

C. Practical Consequences

Like most Supreme Court decisions, lower courts and litigants will likely be arguing for years the meaning and impact of this new decision. Some of the issues and likely consequences of this important decision include the following:

1. Somewhat More Dismissals. With respect to pending securities class action lawsuits for which the motion to dismiss has not yet been ruled upon, more of those cases will likely be dismissed as a result of this decision. However, it is doubtful that the percentage of those cases being dismissed will increase dramatically. The Second, Third and Eleventh Circuits had already rejected plaintiffs' price inflation theory and only the

Eighth and Ninth Circuits had adopted that theory. Besides, most securities class action lawsuits are filed following a significant stock drop directly attributable to a corrective disclosure, in which case the price inflation theory is irrelevant. In pending cases which survived a motion to dismiss, many judges will probably be unwilling to reconsider the motion to dismiss based on this new decision and will find sufficient issues of fact to deny a motion for summary judgment.

2. Future Complaints. Plaintiffs will likely refrain from filing future securities class action lawsuits in the absence of a significant stock drop immediately following a corrective disclosure. This will not likely result in fewer securities class actions being filed, but simply a more disciplined focus by plaintiff lawyers on only cases involving obvious loss causation.
3. Damage Calculations. Perhaps the most important long-term consequence of the decision will be the Court's discussion of factors causing and not causing plaintiff damages. Defendants are now better equipped to challenge traditional plaintiff-style damage analyses which typically ignore various factors impacting stock price. Although the Court recognized that a "tangle of factors" affects stock price and only some of which may cause recoverable damages, the Court provided no guidance on how one should determine the amount of recoverable damages in light of these numerous factors. The damage experts for plaintiffs and defendants will continue to reach vastly different conclusions on the amount of damages in a particular case, but the plaintiff-style analysis should be lower as a result of this decision since the analysis will need to address the various non-fraud factors if the analysis will have any credibility.
4. Class Certification. The decision may in some cases also help defendants defeat class certification by showing the proposed class representative does not have a valid claim. The Supreme Court confirmed that if a purchaser of stock during the class period sells that stock before the corrective disclosure occurs, the purchaser will not have suffered any loss and thus does not have a viable Section 10(b) claim. If the proposed class representative is such an "in-and-out" investor, defendants should be able to defeat class certification because the claim by the proposed class representative is not typical of the allegedly valid claims by the other class members.
5. Section 11 Claims. The *Dura Pharmaceuticals* case involved loss causation under Section 10(b) of the Securities Exchange Act of 1934, but its ruling should also be helpful to defendants in claims under Section 11 of the Securities Act of 1933 (i.e. claims alleging misrepresentations in a registration statement filed with the SEC in connection with a securities offering). Although plaintiffs need not prove loss causation to establish a claim under Section 11, defendants may prove as an affirmative defense that plaintiffs' damages are not attributable to defendants' alleged

misrepresentations or omissions. As a result of the new Supreme Court decision, this so-called “negative causation” defense presumably now exists if there is no material drop in stock price as a result of a corrective disclosure after the securities offering.

6. Pleading Standard. The Supreme Court expressly left open the question whether plaintiffs must plead loss causation with particularity, which is the pleading standard for scienter. At a minimum, plaintiffs must include within their complaint a “short and plain statement” regarding what is the plaintiffs’ alleged economic loss and what is the causal connection between that loss and the alleged misrepresentations. The Court did not view such a requirement as being burdensome for a plaintiff. Without such a requirement, the Court observed that private securities class action litigation would be transformed into a “partial downside insurance policy,” allowing a plaintiff with a largely groundless claim to litigate in the hope of leveraging a settlement. Lower courts will continue to define this pleading requirement, probably with varying conclusions.

D. Calculating Damages

Pursuant to this new Supreme Court decision, a stock’s true value on the date a class member purchased the stock is irrelevant in determining if loss causation exists (i.e. whether class members suffer recoverable damages under Section 10(b)). However, the stock’s true value on the date of purchase remains relevant in determining the amount of damages once loss causation is established. In a Section 10(b) claim, class members may generally recover no more than the difference between the price paid for the security and its true value at the time of purchase absent the misrepresentation. In other words, a stock’s true value at the time of purchase is not relevant in determining if the defendants are liable, but is relevant in determining the amount of damages once liability is established.

How damages are calculated in a securities class action is far from clear. Experts for plaintiffs and defendants typically reach vastly different conclusions. Because the settlement value of a case is based in large part on the damages exposure of the defendants, defendants and their insurers need to understand the proper elements of a damage analysis and determine the defendants’ most realistic damages exposures. The new Supreme Court decision should assist defendants in refuting the typically large damage calculations by plaintiffs.

Three variables impact the amount of damages in a securities class action: the length of the class period; the number of shares in the class; and the true value of the shares when purchased during the class period. Each of those three variables is discussed below.

Length of Class Period. The longer the class period (i.e. the longer the defendants are alleged to have deceived investors), the larger the damages since more shares were purchased at an inflated price. Although highly important to a damage analysis, the

relevant class period is rather subjective to determine. Frequently, it is not clear when defendants first began misrepresenting information. Usually, plaintiffs arbitrarily select as a start of the class period a SEC filing or public statement by defendants long before the corrective disclosure. When plaintiffs file their motion for class certification, discovery is usually not completed so the court is unable to determine when the alleged deception in fact began. As a result, courts typically will conditionally certify the class period alleged by plaintiffs and reserve the right to later adjust that class period as appropriate, based upon the facts proven at trial. That means an unreasonably long class period usually exists when the parties engage in settlement negotiations.

In many cases, the end of the class period is far less controversial because a corrective disclosure is made that results in an immediate and significant stock drop. In some cases, though, a dispute can arise as to the proper date to end the class period. For example, if the defendants make several corrective disclosures towards the end of the class period relating to the matters at issue in the class action lawsuit, defendants may argue the first of those disclosure ends the class period, whereas plaintiffs may argue the last of such disclosures ends the class period.

When performing a damage analysis, plaintiffs' damage expert will use the generous class period alleged in the complaint and conditionally approved by the court, even though the provable facts may not support such a long class period. On the other hand, a defense-style damage analysis will seek to determine the proper date to start and stop the class period based on the actual facts. In many cases, this results in a much shorter class period than used by plaintiffs and thus much smaller damages.

Number of Shares in Class. Once the length of the class period is determined, it is rather easy to calculate the number of shares traded during that class period since daily trading volume information for a particular stock is readily available. However, not all shares traded during the class period are included within the class for purposes of calculating damages. For example, shares traded by directors, officers and other company insiders are usually excluded from recovery. In addition, shares that were both purchased and sold during the class period are excluded, since those purchasers suffered no loss. Although those purchasers allegedly purchased the shares at an artificially inflated price, they likewise sold the shares at the artificially inflated price, thereby gaining a windfall that offset their original loss.

There is no precise way to determine how many of the shares purchased during the class period should be excluded because they were later sold during the class period. Damage experts have developed various models to estimate the number of these "in-and-out" shares. Not surprisingly, the models used by the plaintiffs' damage experts exclude far fewer shares than the models used by the defendants' experts. Relatively few court decisions address the legitimacy of these varying models since damages issues are typically not litigated until shortly before or at trial. The decisions which exist, though, frequently uphold the defense-style models and reject the plaintiffs-style models. See, e.g. *Kaufman v. Motorola, Inc.*, 2000 WL 1506892 (N.D. Ill. Sept. 21, 2000); *In re Northern Telecom Ltd. Securities Litigation*, 116 F. Supp. 2d 446 (S.D.N.Y. 2000).

Ultimately, the number of shares purchased during the class period and held to the end of the class period can only be determined with certainty through the proofs of claim submitted by class members at the end of the litigation. Each class member must certify in the proof of claim the date they purchased the shares and whether they sold or retained the shares through the end of the class period. However, these proofs of claim are not submitted until after the class action is settled or tried, and therefore that information is unavailable when the parties negotiate a settlement.

Ironically, the number of shareholders who actually recover damages through a settlement or trial of the class action is far less than the number who qualify to be included in the class. Many shareholders who are entitled to participate in the recovery do not file the required proof of claim, either because they do not learn about the settlement, they no longer have the documents necessary to prove their entitlement or they do not bother with the paperwork. For that reason, defendants and their insurers prefer a “claims-made” settlement or judgment, pursuant to which the settlement or judgment amount is enumerated on a per share basis rather than as an aggregate number. Under this approach, the amount paid by the defendants and their insurers is determined by the number of shares for which a valid proof of claim is actually submitted, not the number of shares for which a valid proof of claim potentially could be submitted. Obviously, that approach significantly reduces the liability of the defendants.

Because the total amount payable by the defendants and their insurers under a claims-made settlement is not known when the per-share settlement amount is negotiated, plaintiffs’ lawyers are unwilling to agree to claims-made settlements for fear their fees will be dependent on the number of proofs of claim actually filed. Instead, plaintiffs insist on a defined aggregate settlement amount which is allocated among whatever number of shares ultimately participates in the settlement. Under this aggregate settlement approach, the more shares that participate in the settlement, the smaller the per-share recovery, and vice versa.

A few courts have addressed whether damages should be determined at trial on a per-share or aggregate basis. Courts have usually held that any damage award by a jury or court should be a per-share damage award. In other words, the amount recovered by shareholders should be based on their actual damages and not be dependent on the number of other shares for which valid proofs of claim are submitted. Because only a portion of the shares that qualify for recovery will actually submit a valid proof of claim, the defendants’ true financial exposure at trial is typically far less than even a defense-style damage analysis, which is based on the total number of shares that qualify for recovery.

True Value. Determining a stock’s true value throughout the class period, assuming no misrepresentations, is the most difficult and controversial aspect of calculating damages. A simple plaintiffs-style analysis frequently assumes that the amount of the stock drop following the corrective disclosure at the end of the class period is the amount by which the stock price was artificially inflated throughout the class. Thus, the amount of that stock drop is multiplied by the number of shares in the class to determine the total damages.

The *Dura Pharmaceuticals* decision now makes clear that such a simplistic methodology for determining a stock's true value is improper. The Supreme Court recognized that a lower stock price following a corrective disclosure may reflect a number of factors unrelated to the corrective disclosure, including changed economic circumstances, changed investor expectations, and new industry-specific or firm-specific facts or conditions. It is now clear that only the portion of the stock drop attributable to the corrective disclosure is relevant to a damage analysis. However, it is far from clear how one should determine what portion of the stock drop is allocable to litigation-related matters and what portion is allocable to other factors.

To measure the portion of the stock drop attributable to economy-wide and industry-wide events, damages experts use a technique called linear regression and correlation. Under this technique, the expert analyzes the extent to which a company's stock price historically responds to these types of events and information, and the sensitivity of the stock's price to such information, the stock performance of similar companies impacted by the same events. That historical sensitivity and comparability analysis is then applied to the company's stock performance during the class period to exclude the impact of economy-wide and industry-wide events. The remaining portion of the stock drop that is not attributable to these economy-wide and industry-wide events is called the residual price change.

The damages expert then seeks to determine what portion of the residual price change is attributable to the corrective disclosure and what portion is attributable to company-specific factors unrelated to the misrepresentations. Typically, the expert conducts an event study to evaluate the correlation between stock price changes during the class period and various events that occurred. This allows the expert to determine the extent to which the stock drop is in response to those other events rather than the corrective disclosure.

The final step in the damages analysis is to determine if the stock price recovered during the 90 days immediately following the corrective disclosure (i.e. following the end of the class period). Pursuant to the Private Securities Litigation Reform Act of 1995, damages in a securities class action may not exceed the difference between the price paid by the class member for the security and the average trading price of the security during the 90-day period after the corrective disclosure. 15 U.S.C. §78u-4(e). In other words, if the corrective disclosure causes only a temporary drop in the stock price, the resulting damages are reduced and may be eliminated.

E. Conclusions

The *Dura Pharmaceuticals* decision should have at least a short-term positive effect on a modest percentage of pending securities class action lawsuits by increasing the likelihood the cases will be dismissed. However, given the creativity, resolve and flexibility of the plaintiff bar, the long-term positive impact of the decision on the frequency of cases being dismissed will probably not be great. The more lasting impact, though, relates to how damages are calculated. The Supreme Court confirmed that a proper damage analysis may not include the portion of the stock drop attributable to the

“tangle of factors” impacting a stock price which are independent of the alleged misrepresentations.