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Securities Litigation Trends

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LITIGATION UPDATE: RECENT TRENDS IN SECURITIES LITIGATION

RECENT DECISIONS

U.S. Supreme Court Sets Forth Standard for Pleading and Proving Loss Causation in Securities Fraud Class Actions

DURA PHARMACEUTICALS, INC., ET AL. V. BROUDO, ET AL.
(U.S. SUPREME COURT, APR. 19, 2005)

Finding that the plaintiffs failed to sufficiently allege loss causation, the Supreme Court unanimously reversed the Ninth Circuit Court of Appeals. The plaintiffs bought stock in Dura Pharmaceuticals, Inc. ("Dura") on the secondary market between April 1997 and February 1998. Subsequently, they brought a private securities fraud class action against Dura and some of its officers and directors for alleged false statements concerning, among other things, the expectation that Dura's new spray device for use in the treatment of asthmatics would be approved by the Food and Drug Administration ("FDA"). The plaintiffs alleged that they paid an inflated price for the stock because of the alleged misrepresentations.

The district court granted the defendants' motion to dismiss based upon a failure by the plaintiffs to allege a causal connection between their economic loss, represented by a drop in the price of Dura's shares, and the alleged misstatements regarding expected FDA approval for the Dura spray device. The Ninth Circuit reversed and found these allegations sufficient. More importantly, the Ninth Circuit articulated a standard for proving loss causation that did not require plaintiffs to demonstrate a causal link between the drop in stock price and the alleged misrepresentation. In support of this conclusion, the Ninth Circuit found that a securities plaintiff's injury occurs at the time the stock is purchased at an inflated price.

The Supreme Court reversed and noted that an inflated purchase price, by itself, will not establish a causal connection between the alleged fraudulent misrepresentation and the claimed economic loss. Rather, the Court found that "at the moment a transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share of stock that at that instant possesses equivalent value." The Court correctly recognized that if the purchaser later sells that share at a lower price, that lower price may reflect things unrelated to the earlier misrepresentation, such as changed economic circumstances or changed investor expectations. Therefore, even though an inflated purchase price may sometimes play a role in bringing about a future loss, it may not be the sole or significant cause of the loss. The Court also observed that the "securities statutes seek to maintain public confidence in the marketplace," but in doing so they impose the burden on plaintiffs to show

that the defendant's misrepresentations actually caused the plaintiff to suffer dollar damages. The Court thus rejected the Ninth Circuit's approach, which would have allowed plaintiffs to recover by showing only that the alleged misrepresentation caused the price of the stock to be inflated on the date of purchase.

Significantly, the Court also found that the plaintiffs' pleading was lacking in specificity. The complaint alleged only that the plaintiffs' loss was caused by the payment of "artificially inflated prices for Dura's securities." The Court recognized that Fed. R. Civ. P. 8(a)(2) requires only a "short plain statement of the claim showing that the pleader is entitled to relief." However, the Court went on to hold that it was not unreasonable to require a plaintiff who claims to have sustained an economic loss to plead the nature of that loss and facts demonstrating that the loss was causally connected to the alleged misstatement. Because the plaintiffs' complaint failed to do this, the Court found it legally insufficient.

The Supreme Court's holding in *Dura* will provide securities defendants with an additional argument to combat baseless claims of securities fraud. The Court's mandate regarding the pleading of loss causation will require plaintiffs to set forth in their complaints the causal connection between the decline in the stock price and the alleged fraud. The Court's clarification of the loss causation standard also will provide fertile ground on which to attack plaintiffs' experts at trial.

Second Circuit Holds That SLUSA Does Not Preempt "Holder" Claims

Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc. (2d Circuit, Jan. 11, 2005)

The Second Circuit recently aligned itself with its sister circuits in holding that in order to trigger the preemption provisions of the Securities Litigation Uniform Standards Act ("SLUSA") a state case must involve a claim of fraud in connection with the purchase or sale of a security, as opposed to mere "holder" claims. Shadi Dabit ("Dabit"), a former broker of Merrill Lynch, brought a putative class action under state law in the United States District Court for the Western District of Oklahoma on behalf of himself and other current and former Merrill Lynch brokers who owned and continued to hold Merrill Lynch-recommended securities based on Merrill Lynch's allegedly misleading research. Dabit contended that Merrill Lynch overrated certain stocks causing the artificial inflation of their prices. IJG Investments Limited Partnership and Irlys Guy (collectively, "IJG") brought a putative class action against Merrill Lynch in the Minnesota state court. IJG sought damages under state law based on its relationship as a retail brokerage customer of Merrill Lynch and its assertion that Merrill Lynch provided biased investment advice in violation of its contract with IJG. Like Dabit, IJG alleged that Merrill Lynch issued false and misleading reports concerning publicly traded securities in order to garner investment banking business. Both IJG and Dabit alleged that Merrill Lynch misrepresented the value of certain stocks in order to attract investment banking business, all in violation of either Minnesota or Oklahoma law. The IJG action was removed, and both actions were consolidated in the United States District Court for the Southern District of New York. The district court dismissed both actions on Rule 12(b)(6) motions, as preempted by SLUSA. On appeal to the Second Circuit, the principal question was whether Merrill Lynch's purported misrepresentations and omissions were "in connection with the purchase or sale" of the covered securities.

The plaintiffs claimed that their complaints did not seek damages based on the sale or purchase of securities and, accordingly, were not preempted by SLUSA. The Second Circuit disagreed and noted that it was required to look beyond the mere allegations of the complaint in order to examine the nature of the claims asserted, as well as the potential damages available to the plaintiffs. Moreover, the court held that in interpreting the "in connection with" requirement of SLUSA, it would be guided by judicial interpretation of the "in connection

with" language of Section 10(b) of the Exchange Act of 1934 and its corresponding Rule 10b-5.

In applying its holding, the court noted that Dabit asserted claims for two types of damages: (i) "holding" damages related to Merrill Lynch's fraudulent inducement of the putative class to retain certain securities and (ii) damages for anticipated commissions from clients lost as a result of Merrill Lynch's false research reports. The court found that the "holder" class included purchasers of securities, whose claims were preempted by SLUSA. The court noted that given SLUSA's manifest intent to preempt state-law claims alleging fraud in connection with an actual purchase, a would-be "holding" lead plaintiff must expressly exclude from the class those claimants who purchased securities in connection with or reliance on the fraud. Dabit's claim on behalf of the proposed class for commissions lost when customers abandoned Merrill Lynch following disclosure of its improper practices was a different matter, however. That claim relied not on the purchase or sale of any security, but on the loss of commissions from former clients of class members after the fraud was disclosed. Hence, the court held that this claim was not preempted.

With regard to IJG's claims, the court held that while the claims for flat annual fees were not preempted by SLUSA because they did not coincide with a purchase or sale of securities, the claims for commissions paid to Merrill Lynch were preempted because they necessarily involved a purchase or sale of securities in connection with or as a result of Merrill Lynch's alleged fraud. The court agreed with the analyses of the Eighth and Eleventh Circuits, which distinguished between claims based upon acting on misleading investment advice, which necessarily alleged a purchase or sale, and claims which merely asserted that the plaintiff was injured by paying for a service, independent of any given transaction. The court concluded that the "commission claims" giving rise to the counts for breach of contract and violations of the state consumer fraud statutes only accrued when plaintiffs' customers purchased or sold securities through Merrill Lynch. As a result, the claims asserted misstatements or omissions in connection with the purchase and sale of securities and were preempted. In contrast, the claims for the return of annual fees for bogus investment reports avoided SLUSA's preemption provision because an annual fee was paid whether or not the customer acted on the research and bought or sold stock.

The ruling in *Dabit* continues a trend of allowing "holder" class actions to proceed in state court. *Dabit*, however, makes clear the "gatekeeper" function of the federal courts to look beyond the mere allegations of the complaint to analyze claims to their logical conclusion. As such, *Dabit* is likely to spawn more motion practice, as defendants parse the language of complaints in an attempt to find some "purchase" or "sale" element.

VEDDER, PRICE, KAUFMAN & KAMMHOLZ, P.C.

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If you have any questions regarding material in this issue of *Securities Litigation Trends* or suggestions for a specific topic you would like addressed in a future issue, please contact the editor, **Thomas P. Cimino, Jr., at 312/609-7784** or at tcimino@vedderprice.com.

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