Boston Business Journal

Vol. 25, No. 13 April 29-May 5, 2005

Securities suits get higher bar after high court ruling

INSIDER VIEW

Christian M. Hoffman and Matthew C. Baltay

On April 19, the U.S. Supreme Court issued a landmark decision that should provide a measure of relief to many companies facing "fraud on the market" class actions.

The decision, Dura Pharmaceuticals v. Broudo, addresses the requirements of a federal securities suit with respect to proving the cause of losses resulting from misrepresentations made in connection with the purchase or sale of securities.

Justice Stephen Breyer, a former Harvard Law School professor and Massachusetts resident serving on the federal court of appeals, penned the Supreme Court decision overruling the Ninth Circuit. The Ninth Circuit had equated the cause of economic loss with the mere inflation of a stock price attributed to a misrepresentation. The Supreme Court ruled that to be error: Federal securities fraud claims must now establish that the stock price loss for which suit is brought was caused by a disclosure of the truth underlying the fraud alleged.

Shareholders of Dura Pharmaceuticals, a San Diego-based respiratory drug company, brought suit charging that during a 10-month period the company misled the market by intentionally overstating its prospects of obtaining FDA approval of a new asthma sprayer. Plaintiffs alleged that when they made their stock purchases, Dura's share price was artificially pumped up by the company's misstatements about prospects for the new drug device.

Dura's stock price later dropped 50 percent when Dura revised its earnings projections downward due to slow drug sales. The shareholders sued on the basis of that drop but did not allege that the drop was caused by any news concerning the new asthma sprayer (which had not yet been approved for sale). Indeed, months later, when Dura announced its failure to secure FDA approval for the sprayer, its stock price dipped only temporarily. The Ninth Circuit sided with the plaintiffs and ruled price inflation alone caused by alleged company fraud could give rise to company liability for a later stock price decline, without regard to what caused that decline, as injury occurs at the time of stock purchase.

In rejecting the Ninth Circuit's inflation model, the court reasoned that "as a matter of pure logic," an investor who purchases at an allegedly inflated price loses no money when he buys and indeed may well sell at a gain. Investor loss only occurs when the stock price drops. As Justice Breyer observed, however, a stock price may drop for any number of reasons other than fraud, including "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events."

Allowing investors to recoup their losses when something other than disclosure of fraud causes a stock price drop would grant investors a "broad insurance against market loss," a result without statutory, SEC rule or common law support. The high court ruled, accordingly, that in order to pursue their securities fraud claims, plaintiffs must connect their stock losses with disclosure of the truth.

The Dura decision may have a further welcome effect on Massachusetts state law. In 2003, the Massachusetts state appeals court decided a state common law fraud case against auditing firm KPMG and explicitly rejected, on questionable grounds, the very loss causation regime adopted in Dura.

Dura's compelling reasoning, rooted in centuries-old principles of common law, may nevertheless prompt our state appellate court to rethink this local precedent the next time it considers a case of fraudulent misrepresentation.

CHRISTIAN M. HOFFMAN is a partner and **MATTHEW C. BALTAY** is an associate in the Boston office of Foley Hoag LLP.