DURA PHARMACEUTICALS v. BROUDO: THE UNLIKELY TORT OF "SECURITIES FRAUD"

OLEG CROSS*

I. INTRODUCTION

Created pursuant to section 10 of the 1934 Securities Act,[1] Rule 10b-5 is a cornerstone of the federal securities laws. The federal courts' interpretations have largely defined the rule, which seeks to remedy a broad range of securities fraud and market manipulation. Elements of the rule, such as "scienter" and "reliance," were defined at length by earlier court decisions. However, no court had definitively held whether a private plaintiff must demonstrate a causal connection between an alleged fraud and the subsequent loss to that plaintiff. This issue, referred to as "loss causation," was decided by the Supreme Court in Dura Pharmaceuticals, Inc. v. Broudo.[2] The Court, reversing a prior Ninth Circuit Court of Appeals, held "loss causation" must be established in every case brought under Rule 10b-5 by pleading and proving a causal connection between the alleged fraud and the subsequent loss. This new requirement is commonly believed to have changed the landscape of private securities litigation, establishing a higher pleading hurdle in all securities-fraud cases. Interestingly, as this Commentary demonstrates, the federal securities laws contain no foundation for, nor any history of, the requirement of "loss causation." Instead, the element of "loss causation" recently added to the pleading requirements of a securities fraud claim is a product of tort law, economic analysis, and common sense.

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* 2006 J.D. Candidate, Duke University School of Law.

1. 15 U.S.C. § 78a et seq. (2000).
2. Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005).

II. FACTUAL AND PROCEDURAL HISTORY

The plaintiff-class was stockholders in Dura Pharmaceuticals, Inc., ("Dura") who had purchased Dura stock on the public market. This purchase led to the subsequent securities fraud class action against Dura.[3] Plaintiffs' theory of the case was that "[i]n reliance on the integrity of the market, [the plaintiffs] . . . paid artificially inflated prices for Dura securities," causing the plaintiffs to suffer damages.[4] The class alleged that Dura or its officials made false statements concerning profits; falsely claimed that drug sales were expected to be profitable; and falsely claimed that the FDA would soon approve its asthmatic spray device.[5] Plaintiffs further alleged that the company subsequently announced that its earnings would be lower than expected due to slow drug sales, and the company's share price declined.[6] The allegations also chronicle a Dura announcement, eight months following the sales announcement, that the FDA would not approve Dura's asthmatic spray device. The day following that announcement Dura's share price fell again, though it almost fully recovered a week later.[7]

The district court dismissed the complaint, holding that the drug-profitability claim failed to allege an appropriate scienter, and that the spray-device claim failed adequately to allege "loss causation."[8] The Ninth Circuit reversed, holding that the complaint adequately alleged "loss causation,"[9] basing its decision on the theory that "plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation."[10] The court added that "the injury occurs at the time of the transaction," and because the complaint pleaded "that the price at the time of purchase was overstated," these allegations were sufficient to prove "loss causation."[11]

The Supreme Court granted review of the Ninth Circuit decision in order to settle a split between the Circuits and their varying

3. *Id.* at 339.
4. *Id.*
5. *Id.* at 340.
6. *Id.*
7. *Id.*
8. *Id.*
9. Broudo v. Dura Pharms., Inc., 339 F.3d 933, 938 (9th Cir. 2003).
10. *Id.*
11. *Id.*

versions of "loss causation."[12] The Ninth Circuit, unlike other Courts of Appeal, held that the element of "loss causation" is satisfied by the allegation that share price at the time of the purchase was inflated.[13] More specifically, the Ninth Circuit held that a plaintiff need not allege a subsequent drop in price to meet the injury requirement because the injury occurs at the time of the transaction.[14]

By contrast, the Second Circuit held that a plaintiff cannot allege merely that had he known the true "investment quality" of the stock he would not have purchased it. Such allegations are simply assertions and do not answer the question of why the money was lost.[15] The court concluded that, "plaintiffs demonstrate a causal connection between the content of the alleged misstatements or omissions and 'the harm actually suffered.'"[16]

Similarly, the Third Circuit has held that "[w]here the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation."[17] Moreover, the Third Circuit's decision has gone a step further, holding that the plaintiff must demonstrate not only a causal connection between misrepresentation and decline in price, but also a "correction in the market price," which would cause an inflated price to drop and thereby harm the plaintiff.[18] Absent such "correction," a plaintiff can sell securities at the inflated price, thus suffering no loss.[19]

The Eleventh Circuit took an approach that was a less-than-clear case-by-case analysis. A plaintiff need not prove that the misstatement by the defendant was the sole cause of loss, but that it was a "'substantial,' i.e., a significant contributing cause."[20] On the other hand, the Seventh Circuit, held that "'loss causation' is just an exotic name for a standard requirement of tort law," equating "loss

12. *Compare Broudo*, 339 F.3d at 933, *with* Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 198 (2d Cir. 2003); Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000); Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447–48 (11th Cir. 1997); Bastian v. Petren Res. Corp., 892 F.2d 680, 685 (7th Cir. 1990).

13. *Broudo*, 339 F.3d at 938.

14. *Id.*

15. *Emergent Capital*, 343 F.3d at 198.

16. *Id.* at 199.

17. *Semerenko*, 223 F.3d at 185.

18. *Id.*

19. *Id.*

20. Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997).

causation" to "proximate cause."[21] The Seventh Circuit's decision concerning "loss causation" may have influenced the Supreme Court's analysis in *Dura*.

III. HOLDING

The Supreme Court reversed the Ninth Circuit and rejected the notion that a plaintiff only has to allege price-inflation due to the defendant's misrepresentation.[22] Rather, the Court held that in Rule 10b-5 cases, inflated price "will not itself constitute or proximately cause the relevant economic loss."[23] In doing so, the Court appeared to have adopted the Seventh Circuit "no hurt, no tort" proximate cause approach to loss causation.[24] Moreover, the Court went a step further than the Third Circuit, reasoning that, even if sold later at a lower price, the decline may not be due to the market correction of such misrepresentation, but to other independent factors.[25] Such factors, the Court explained, could be "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events."[26] The Court concluded that, though an inflated purchase price may sometimes result in a future loss, the former does not cause the latter as a matter of law.[27] This decision was largely based on the Court's conclusion that to allow recovery based on a simple allegation of misrepresentation would be "to provide investors with broad insurance against market losses, [instead of protecting] them against those economic losses that misrepresentations actually cause."[28]

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21. Bastian v. Petren Res. Corp., 892 F.2d 680, 685 (7th Cir. 1990).
22. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342–43 (2005).
23. *Id.*; *see* 15 U.S.C. § 78(b); *see also* 17 C.F.R. 240.10b-5. Rule 10b-5 prohibits any fraud or manipulation in connection with the purchase or sale of a security registered on a national exchange.
24. *Compare Dura Pharms., Inc.*, 544 U.S. at 342–43, *with Bastian*, 892 F.2d at 685.
25. *Compare Dura Pharms., Inc.*, 544 U.S. at 342–43 ("If the purchaser sells later after the truth makes its way into the market place, an initially inflated purchase price *might* mean a later loss. But that is far from inevitably so."), *with* Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) ("In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.").
26. *Dura Pharms., Inc.*, 544 U.S. at 343.
27. *Id.* at 346.
28. *Id.* at 345.

IV. ANALYSIS

The Court's decision in *Dura*, albeit not intentionally, evidences the pre-existing tensions between both securities law and tort law and between deterrence and fairness. An overriding purpose of the federal securities laws in general, and of the Securities Exchange Act of 1934 ("1934 Act")[29] specifically, is to ensure public confidence in the national financial markets by deterring fraud and encouraging disclosure, in part, through the availability of private securities fraud actions,[30] the scope of which is defined by the Private Securities Litigation Reform Act ("Reform Act").[31] In an effort to further the deterrent goals of the federal securities laws, the Reform Act provides for a number of punitive measures. For instance, section 21 of the Reform Act provides that the Securities and Exchange Commission ("Commission") may "in its discretion" investigate any person, and if the court determines that the person has violated any section of the 1934 Act, including section 10(b),[32] the court may, pursuant to section 21, impose a penalty on the violator.[33] The amount of penalty is to be determined by the court in light of the circumstances, and ranges from $5,000 to $100,000 for a natural person and from $50,000 to $500,000 for a corporate entity.[34] Alternatively, the court may impose a penalty in the "gross amount of pecuniary gain to such defendant as a result of the violation."[35] Thus, as long as the Commission can show that the defendant violated section 10,[36] the defendant can face a penalty regardless of any loss the defendant corporation's shareholders may have suffered.

Based on the Court's decision in *Dura*, however, a plaintiff bringing a 10b-5 action cannot recover based only on the violation of

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29. 15 U.S.C. § 78a et seq. (2000). In addition to the anti-fraud provisions of the Securities Act of 1933, Section 10 of the 1934 Act provided private purchasers of securities with a remedy against fraud.
30. Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986); Theodore Altman et al., 1-1 *Federal Securities Exchange Act of 1934* § 1.01 (2005).
31. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).
32. 17 C.F.R. 240.10b-5. Rule 10b-5 derives from § 10 of the Act. *See* 15 U.S.C. § 78j.
33. *Id.* § 78u.
34. *Id.* § 78u(d)(3)(B)(i).
35. *Id.*
36. 15 U.S.C. § 78j(b). Section 10(b) prohibits the "use or employ, in connection with the purchase or sale of any security, . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."

Section 10 of the 1934 Act; instead, the plaintiff must prove that its loss was proximately caused by the defendant.[37] This disparity appears to run counter to the fraud-deterrent purpose of the federal securities laws, which, considering section 21 of the Reform Act, emphasizes liability for violation irrespective of resultant harm.[38]

Furthermore, section 21D(b)(1) of the Reform Act, which governs private securities fraud actions, likewise provides nothing concerning proximate cause.[39] Section 21D(b)(1) requires that the complaint specify each allegedly misleading statement, the reason why it may be misleading, and the surrounding facts of why the statements are believed to be false.[40] Subsection (b)(2)[41] provides that the plaintiff must prove that the defendant acted with "a particular state of mind" (i.e. "knowingly" or with "scienter").[42] However, the Reform Act is silent on the requirements of economic loss or causation.[43] Plainly, there is nothing in the history of sections 10 of the 1934 Act or sections 21 and 21D of the Reform Act that implicates "proximate cause."

The credit for initially attaching the requirement of proximate cause to Rule 10b-5, which, in essence, linked securities law to tort law, appears to go to Judge Richard A. Posner.[44] Although federal courts have applied tort law principles to 10b-5 actions before,[45] Judge Posner was the first to interpret section 10 and Rule 10b-5 in light of

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37. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

38. 15 U.S.C. § 78u(d)(3)(A) ("Whenever it shall appear to the Commission that any person has violated any provision of this Act . . . the Commission may bring an action in a United States district court to seek . . . a civil penalty to be paid by the person who committed such violation.").

39. 15 U.S.C. § 78u-4.

40. *Id.* § 78u-4(b)(1).

41. *Id.* § 78u-4(b)(2).

42. *Id.*

43. Similarly, Hazen's *Law of Securities Regulation*, cited by the Court in *Dura*, does not mention "proximate cause" in its definition of "loss causation," and instead limits the extent of required causation to the statutory "in connection with" – a causation standard that has been previously interpreted by the courts as "de minimus touch." THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION, §§ 12.11[1], [3] (2002); *see also Dura Pharms., Inc.*, 544 U.S. at 342; Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1028 (6th Cir. 1979) (noting that "the alleged deceptive practice only need be 'touching' the sale of securities").

44. Bastian v. Petren Res. Corp., 892 F.2d 680, 685 (7th Cir. 1990).

45. *See, e.g.,* Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983) (applying tort principles to find an implied right of action against aiding and abetting a section 10(b) violation); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966) (applying RESTATEMENT (SECOND) OF TORTS § 876 to section 10(b) actions).

basic notions of tort law and economic efficiency.[46] At the heart of Judge Posner's argument for reading proximate cause into Rule 10b-5 is his proposition that "[n]o social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through office memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation."[47] Judge Posner's arguments, or their subsequent rendering, appeared to resonate with the Supreme Court in *Dura*. In the words of Justice Souter: "If you have no damages, you have no cause—I mean, on normal tort theory, you have no cause of action."[48]

At first glance, framing a securities fraud action in tort terms appears disconnected from the original purpose of the 1934 Act—to deter fraud and to encourage disclosure.[49] After all, if, after finding a mistake in the offering materials and seeing a subsequent share decline, a plaintiff brings suit, is the fraud-deterrent goal of the 1934 not served by a finding of liability irrespective of any connection between the mistake and the share decline? It is not. The anti-fraud provisions of the federal securities laws are designed to prevent (and punish) fraud—not honest mistakes. Furthermore, the concept of a "causation-free" securities fraud remedy would ultimately hurt investors by unjustly forcing them to absorb the costs of meritless securities fraud litigation, undermining the purpose of the 1934 Act and all other federal securities laws.

V. CONCLUSION

Even after the enactment of the Reform Act, which was designed to curb meritless claims, securities fraud actions have continued to be so ubiquitous and have such a high potential for abuse that they have become a means for investors to hedge against market risks.[50] A particularly unfortunate by-product of the pre-*Dura* causational uncertainty in securities fraud cases is the so-called "strike suit"—a meritless claim that has little chance of success in court, but may

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46. *See Bastian*, 892 F.2d at 685.
47. *Id.*
48. Transcript of Oral Argument at 35, *Dura Pharms., Inc.*, 54 U.S. 336 (No. 03-932).
49. 49.Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986); Altman, *supra* note 30, at § 1.01.
50. *See* William S. Feinstein, *Pleading Securities Fraud With Particularity—Federal Rule of Civil Procedure 9(b) in the Rule 10b-5 Context: Kowal v. MCI Communications Corporation*, 63 GEO. WASH. L. REV. 851, 852 (1995) (discussing the ubiquity of meritless claims).

compel the defendant to settle for an amount far in excess of the claim's verdict value."[51] Strike suits can have a catastrophic effect on a company's financial well-being because of the severe stigma attached to the defendant company charged with an anti-fraud violation under the 1934 Act.[52] Even worse, as the defendant company's value declines in the public market, the taint of securities fraud allegations ultimately hurts innocent investors.

The Court's decision in *Dura* did more than impose an exacting pleading standard in securities fraud actions—*Dura* eliminated the possibility of senseless harm to innocent companies and investors, which creates a better-controlled private anti-fraud litigation regime and engenders investor confidence.

51. *Id.* at 864; *see* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975) ("[A] complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment."); Surovwitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966) (discussing the filing of strike suits "to coerce corporate managers to settle worthless claims in order to get rid of them").

52. *See* Feinstein, *supra* note 50, at 852.