FEDERAL SECURITIES LITIGATION UPDATE:
THE SUPREME COURT REINS IN FRAUD CASES
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The recent announcement of Sandra Day O'Connor's resignation from the Supreme Court, and the deteriorating health of Chief Justice Rhenquist, inevitably point to an even more conservative Court, particularly in the Court's trend to rein in what the Administration refers to as "pernicious" class action securities litigation. The Court's recent decision in *Duro Pharmaceuticals, Inc. v. Broudo et. al.* is an indication of just how serious an increasingly conservative Court will be in minimizing and attempting to eradicate class action securities fraud litigation leaving small investors at the mercy of the companies in which they invest.

The Facts of The Case
The plaintiffs in Duro, represented by class action guru William Lerach, consisted of individuals who purchased shares of Duro Pharmaceuticals between the Spring of 1997 and early 1998. The Complaint alleged that Duro- a San Diego based firm that had two asthma treatment drugs pending before the Food and Drug Administration- had disseminated materially false misrepresentations about the effectiveness of those drugs and their sales prospects. The Company's news releases indicated that the sales of the drugs were strong and the treatments had been testing well in anticipation of approval by the FDA. The stock price reached a high of $53/share but, the day after the Company announced that, in fact, sales had been declining and the drugs had failed to obtain FDA approval, the stock price plummeted by almost 50%. The Complaint, brought on behalf of investors who purchased the stock during the period between the alleged misleading public announcement and the sharp, one day price drop, alleged the investors had lost substantial sums based upon the knowing falsity of the public announcement which propelled the stock upwards in price.

The District Court dismissed the Complaint on the grounds, amongst others, that the class plaintiffs failed to adequately allege "loss causation"; that is, the complaint failed to sufficiently allege that there was a direct nexus between the alleged misleading, positive public announcement that raised the stock price and the subsequent decline in the stock price after the truth was disclosed.

The Ninth Circuit Federal Court of Appeals reversed the District Court, finding that the Complaint did adequately allege "loss causation", holding that the injury to the class of investors occurred *"at the time of the transaction"* and, since the class alleged that the "price at the time of purchase was overstated", the allegations of the Complaint were legally sufficient. The Ninth Circuit's holding, however, conflicted with that of other Federal Circuit Courts which held that an artificially inflated price, even one artificially inflated by false and misleading public announcements by a company, does not, in and of itself, constitute or proximately cause the relevant economic loss. The Ninth Circuit's reasoning is obvious. If an investor buys a stock based upon materially false and misleading public announcements that a company's product is selling well and has a very good chance of ultimately obtaining FDA approval, which turns out to have been false when made, one would think the standard for at least alleging a classic securities fraud case was met. Not so, ruled the Supreme Court.

The Elements of a Fraud Case Involving Publicly Traded Stock
In reversing the Ninth Circuit and dismissing the Complaint, the Supreme Court outlined the basic elements of a "fraud on the market" securities fraud claim:

1. A material misrepresentation;
2. scienter (ie. a wrongful state of mind; knowledge that the representation was false and misleading);
3. in connection with the purchase and sale of a security;
4. an economic loss; and
5. *"loss causation" (ie. a direct, causal connection between the material misrepresentation and the investor's loss).*

It would seem obvious that all of these elements were satisfied by this Complaint that alleged the investors would not have purchased the stock at the higher, artificially inflated price "but for" the false and misleading public announcement about the company's prospects of continued sales of product and imminent approval by the FDA. After all, when a stock drops almost 50% on the announcement that, in fact, sales had been declining, not increasing, and the FDA did not approve the drugs although the company announced that approval was imminent, what would cause a loss to an investor who purchased the stock at the higher price than the fraudulent, misleading public announcement that propelled the stock to a record high?

The Supreme Court's Narrow Definition of "Loss Causation"
As compelling as the facts of Duro were, the Supreme Court dismissed the Complaint and, in so doing, defined narrowly the concept of "loss causation". While the Ninth Circuit held that the Complaint adequately established that the "price on the day of purchase" was inflated due to the admittedly false and misleading public announcement, the Supreme Court took a much more narrow view and held that "an inflated price will not itself constitute or proximately cause the relevant economic loss". In so doing, the Court looked not at the factors that may have artificially raised the stock price on the day of purchase, but on the reasons for the stocks decline at the time of sale. The Supreme Court held:

> "When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but 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."

While it might seem patently obvious to most readers that the *only* cause for the drop in Duro's stock was the initial, false and misleading public announcement- the very reason any prudent investor would have been motivated to buy the stock in the first place- and the subsequent announcement that stated the first earlier public announcement was incorrect and false, the Supreme Court did not see the connection as sufficient to uphold the class action fraud complaint. The Court refused to interpret the Federal Anti-Fraud Securities laws "to provide investors with broad insurance against market losses" and instead limited the laws only "to protect them against those economic losses that misrepresentations actually cause".

Organizations representing those who lost money in corporate-fraud scandals, including public pension funds and groups such as the senior-citizen lobby AARP and the Consumer Federation of America, urged the Ninth Circuit ruling be upheld. The Administration, on the other hand, which has expressed very negative views of class action securities fraud litigation, urged the decision be overturned. The net effect of the decision is to allow defendants, such as those in *Duro*, who issue admittedly false and misleading statements which bolster the company's stock price, to defend their cases on the ground that there were intervening causes which caused the stock to decline, not solely the initial false and misleading statement.

To a very large extent, the Court's decision in *Duro* effectively eviscerates many of the "fraud on the market" securities fraud claims common to many class action securities cases. Just one more decision by the highest Court to implement the intent of the Private Securities Litigation Reform Act of 1995 and rein in the number and extent of class action, securities fraud litigations.

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