Corporations, Securities & Antitrust

The Supreme Court's 2005-2008 Securities Law Trio: *Dura Pharmaceuticals, Tellabs,* and *Stoneridge*

*By Allen Ferrell**

Business law is clearly an area that the Supreme Court has turned its attention to in recent years with important consequences. Nevertheless, it still remains fair to say that Supreme Court securities law opinions are relatively infrequent, especially in light of the profound impact securities law, and securities litigation in particular, have on the U.S. capital markets and publicly-traded firms. At the same time, the securities opinions the Court does issue typically have a powerful impact and often set the stage for the next set of issues that will become the focal point of litigation. In the last three years there have been three Supreme Court opinions in the securities law field that stand out: *Dura Pharmaceuticals, Inc., v. Broudo*,[1] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[2] and *Stoneridge Investments Partners, LLC v. Scientific-Atlantic, Inc.*,[3] from the most recently concluded term of the Court.

All three of these decisions dealt with the most important source of liability exposure firms and firm management face today: class action litigation utilizing a Rule 10b-5 cause of action. The damage claims presented by plaintiffs in these cases can run into the billions of dollars. And therein lies their importance. Indeed, the Rule 10b-5 liability exposure of a number of U.S. companies has substantially increased recently as a result of a new wave of Rule 10b-5 class action complaints being filed over the course of the last year due to losses arising from subprime and Alt-A mortgage exposure. As of February 18, 2008, there have been 136 class action suits filed based on subprime and Alt-A losses.[4] In the following six months, yet another wave of class action complaints were filed as the losses from subprime and Alt-A mortgages escalated and the number of companies affected by these losses increased.

This article will review these three recent securities opinions focusing on the possible implications these cases hold for the future and the litigation issues that will likely come to fore as a result of the Court's reasoning in these cases. I will begin my discussion with the first, and in many ways the most interesting, of these opinions: the Court's 2005 *Dura Pharmaceuticals* opinion.

I. "Loss Causation": *Dura Pharmaceuticals* and Beyond

In Rule 10b-5 actions, plaintiffs must plead and prove that a defendant's alleged misconduct, such as misreporting financial information in the firm's SEC disclosures, actually *caused* the losses for which plaintiffs are seeking damages. The "loss causation" requirement is of fundamental importance given the huge volume of class action complaints filed against corporate defendants relying on a Rule 10b-5 cause of action and the fact that there are any number of factors that can affect a stock's price over time that have nothing whatsoever to do with the revelation of misconduct by a corporate defendant, such as the market learning of misstated firm financials. Exclusion of these non-fraud factors can have, indeed typically does have, a dramatic effect on the liability exposure of defendants.

The issue of "loss causation" is not only important in Rule 10b-5 actions but also actions brought against corporate defendants pursuant to Section 11 of the Securities Act of 1933; the second most popular cause of action utilized by class action attorneys. Section 11 provides a cause of action for investors under certain circumstances with respect to material misstatements in a firm's registration statement with the default measure of damages being rescissionary damages. However, the defendants can reduce its Section 11 damages to the extent that they can establish that rescissionary damages would exceed the losses actually caused by the material misstatements in the registration statement. In other words, defendants have an affirmative "loss causation" defense in Section 11 actions which can be of critical importance in situations where the stock price has declined significantly over the class period as rescissionary damages are likely to be quite large.

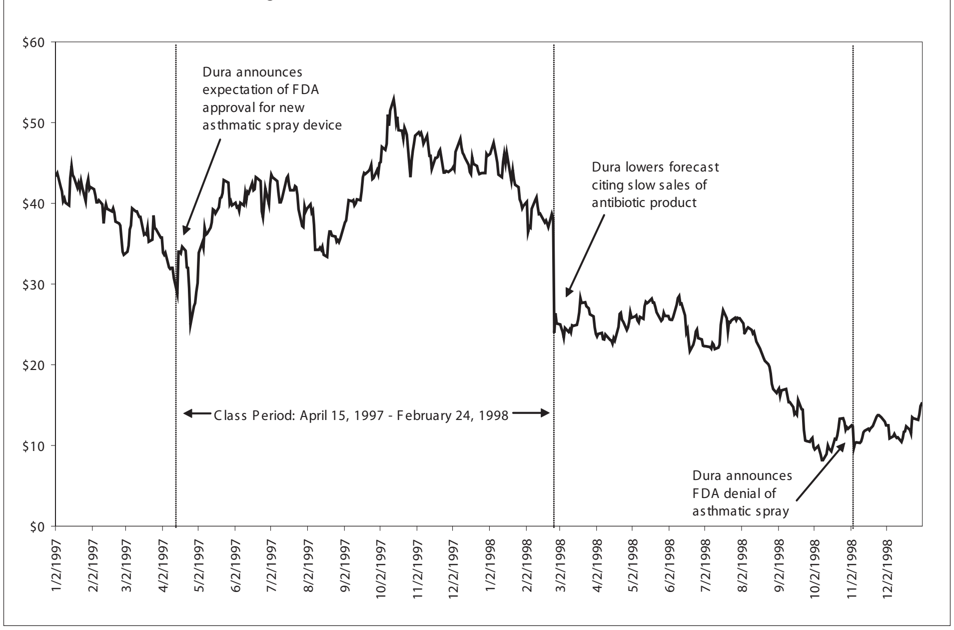
In an unanimous opinion authored by Justice Breyer, the Supreme Court in *Dura Pharmaceuticals*[5] for the first time squarely addressed the "loss causation" requirement in Rule 10b-5 actions. In the *Dura Pharmaceuticals* case itself, the company had publicly announced that it expected FDA approval for a new asthmatic spray device, an announcement which plaintiffs claimed was a misrepresentation. Some ten months later, the Dura Pharmaceuticals Company announced that its sales forecast for one of its antibiotic products were lower than expected, resulting in a steep decline in Dura Pharmaceuticals' stock price. Predictably, a Rule 10b-5 class action lawsuit was filed against Dura Pharmaceuticals with the class period running from the date of the alleged misrepresentation till the release of the lowered sales forecast. Interestingly, a number of months after the lowered sales forecast, Dura Pharmaceuticals did in fact announce the FDA's denial of its application for approval of its asthmatic spray device with no statistically significant stock market reaction associated with the announcement. A chart of Dura Pharmaceuticals' stock price during this time period is summarized in Figure I below. As readily apparent from Figure I (above, right), plaintiffs selected as the end of their purported class period the date with the largest stock price decline.

The Supreme Court concluded that plaintiffs had failed to allege loss causation for the losses they were seeking in their complaint. In the course of its analysis, beyond emphasizing the importance of "loss causation", which in itself has had a substantial impact on subsequent Rule 10b-5 class actions, the Court rejected the Ninth Circuit's position (on appeal from which the

** Allen Ferrell is Greenfield Professor of Securities Law at Harvard Law School.* *He wishes to thank the John M. Olin Center in Law, Economics and Business at the Harvard Law School for financial support.*

case was being heard) that the mere fact that a securities' price might have been inflated at the time of purchase, relative to its true value, as a result of the defendant's alleged misrepresentation concerning the likelihood of FDA approval simply does not establish that any of the plaintiffs' losses were caused by the misrepresentation. The Supreme Court's reasoning on this issue was entirely predictable given that an investor who purchases at an inflated price might well not be harmed given that he or she might sell that same security at an equally inflated price. The Ninth Circuit's position on loss causation was simply at odds with common sense as well as the law of other circuits.

Figure 1: Dura Pharmaceutical Share Prices: 1997 - 1998



More interesting and telling than the Court's rejection of the Ninth Circuit's reasoning is its description of the "loss causation" requirement. In particular, there are three aspects of the Court's opinion that are noteworthy. First, the Court emphasized the common law tort origins of the "loss causation" requirement. Second, the Court stressed the fact that the goal of U.S. securities law, and Rule 10b-5 in particular, is "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." Third, the Court went out of its way to point out that the plaintiffs' failure in their complaint "to claim that [the company's] share price fell significantly *after the truth became known*" (emphases added) undermined the contention that the plaintiffs' losses were in fact caused by the misrepresentation.

This third aspect of the Court's opinion bears further discussion. A number of courts and commentators have interpreted this language as requiring that there be a "corrective disclosure" in order for loss causation to exist.[6] That is to say, the market learning of the Rule 10b-5 actionable misconduct, such as a material misrepresentation, is a necessary prerequisite to a showing of "loss causation." The notion that there must be a "corrective disclosure" in order for there to be "loss causation" long predates the Supreme Court's opinion in *Dura Pharmaceuticals,*[7] but it is the first time that the issue had been discussed by the Supreme Court in the context of the "loss causation" requirement. And the requirement of a "corrective disclosure" has figured prominently in district court and appellate court decisions subsequent to *Dura Pharmaceuticals*. For instance, in a decision released July 25, 2008, the Ninth Circuit explained, in the course of affirming a dismissal of a Rule 10b-5 class action complaint, that in order to plead loss causation a "complaint must allege that the practices that the plaintiff contends are fraudulent were revealed to the market and caused the resulting losses."[8] The court concluded that this was not done in the complaint and hence was properly dismissed.

A key battleground in securities class action litigation in the aftermath of the *Dura Pharmaceuticals* decision has therefore been which types of disclosures will be deemed to be "corrective disclosures." The critical importance of the "corrective disclosure" component of the loss causation analysis was powerfully demonstrated in a decision by the United States District Court for the District of Arizona in August of 2008 in which a jury verdict awarding plaintiffs some $277.5 million in damages in a Rule 10b-5 class action was overturned.[9] The court overturned the jury's finding of damages, pointing to the plaintiffs' failure to provide evidence at trial establishing that there were in fact corrective disclosures revealing to the market the defendants' misconduct.

The identification of a "corrective disclosure" is not only important as it is a necessary precondition to there being "loss causation," however, but also because the stock market reaction to such disclosures (controlling of course for contemporaneous market and industry conditions) will typically constitute the basis for plaintiffs' damage estimates. Accordingly, plaintiffs will tend to argue that disclosures with the largest negative stock market reaction are "corrective disclosures" so as to claim the largest conceivable damage award. Indeed, one of the leading plaintiff's expert witnesses on "loss causation" has argued in print that disclosures which reveal the "true financial condition" of a company that was supposedly being concealed by the defendant's misrepresentations should be deemed to be "corrective disclosures," *even* if the disclosure does not actually reveal the fact that there had been misconduct.[10] Under this aggressive definition of "corrective disclosure" disclosures such as reduced sales forecasts and lower projected earnings which make no reference whatsoever to fraudulent conduct can constitute "corrective disclosures." Needless to say this is an approach that defendants have strongly resisted with some success. Most prominently, the court in *Ryan v. Flowserve Corp.*[11] rejected the "true financial condition" theory of "corrective disclosure" as inconsistent with *Dura Pharmaceuticals*. In short, as it has become clear that corrective disclosures are an integral component of the loss causation analysis, and the stock market reaction thereto, the struggle between plaintiffs and defendants in Rule 10b-5 class action litigation has shifted towards competing interpretations of the concept of "corrective disclosure."

Another important battleground will be the applicability of the *Dura Pharmaceuticals* loss causation analysis to ERISA class action litigation against ERISA plan fiduciaries, including firms with ERISA plans (such as 401(k) and pension plans). These suits are potentially quite costly as there is no need to establish that, as is necessary for a Rule 10b-5 suit, the defendants acted recklessly or intentionally. Directly raising the applicability of the *Dura Pharmaceuticals* loss causation analysis is the fact that plaintiffs are typically more aggressive in their damage estimates in ERISA litigation often claiming as damages losses from declines in the firm's stock price that are due to market-wide or industry-wide stock market movements. This can result in dramatic damage claims in a situation where the market generally is steeply falling.[12] In a Rule 10b-5 action, such losses would clearly be excluded from being considered damages caused by a misrepresentation. The ERISA statute itself merely states that the ERISA fiduciary shall "make good to such plan any losses to the plan *resulting* from each such [fiduciary] breach..."[13] In light of the substantial number of ERISA suits that have recently been filed against investment banks and mortgage originators with ERISA plans, the relevance of *Dura Pharmaceuticals* to the proper interpretation of the word "resulting" will be an important contested issue.

II. *Tellabs* and Pleading

The Supreme Court, some two years after *Dura Pharmaceuticals,* addressed the pleading requirements for Rule 10b-5 actions in its *Tellabs* opinion.[14] The case was widely watched by the securities bar as the risk to defendants poised by class action suits tends to increase once the class action complaint survives a motion to dismiss (and even more so if the complaint survives a motion for summary judgment). In *Tellabs*, the Court concluded that the Private Securities Litigation Act's requirement that plaintiffs must "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind"[15] is satisfied when "an inference of scienter [is as] cogent and at least as compelling as any opposing inference of nonfraudulent intent."[16] Despite the widespread interest in the case, and the reports in the press characterizing the opinion as "pro-defense," the *Tellabs* opinion in fact left relatively little changed in the balance of power between defendants and plaintiffs. This is a function of several aspects of the opinion.

First, and most abstractly, the tone of the opinion with respect to securities class action litigation was more favorable than that of either the *Dura Pharmaceuticals* opinion or the Court's subsequent opinion in *Stoneridge.* The very first line of the opinion states that "meritorious private actions to enforce federal antifraud securities laws" constitute an "essential supplement" to actions brought criminally and civil action brought by governmental agencies. The Court then goes to the trouble of repeating this point later explaining that nothing in the Private Securities Litigation Act "casts doubt" on viewing private securities litigation as an "indispensable tool."[17]

Second, and more specifically, the pleading requirements for Rule 10b-5 actions in some circuits prior to *Tellabs* were actually stricter than that adopted by the *Tellabs* Court. In other words, while *Tellabs* heightened the pleading requirements in some circuits, such as the Seventh Circuit, from which the *Tellabs* was on appeal from, it had the effect of lowering the pleading requirements in other circuits. The First Circuit, for instance, explained that the *Tellabs* pleading standard lowered the requirements adopted by the First Circuit pre-*Tellabs* as to the strength of the inference needed to plead scienter.[18] Proving the point, the First Circuit subsequently reversed a district court's dismissal of a securities class action complaint as it was dismissed pursuant to the First Circuit's pre-*Tellabs* standard, rather than the more forgiving *Tellabs* standard under which the complaint passed muster.[19] For some circuits, such as the Second Circuit, it is doubtful whether there was any meaningful alteration of the pleading standard as a result of the *Tellabs* opinion. For instance, the Second Circuit in a recent case reviewing the dismissal of a complaint failed to even cite *Tellabs* choosing to rely for its analysis on pre-*Tellabs* Second Circuit case law.[20]

Third, there is language in the *Tellabs* opinion that could be used to substantially undermine the pleading standard the Court purported to be adopting. The Court states, "While it is true that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference, we agree with the Seventh Circuit that the absence of a motive allegation is not fatal."[21] This line is potentially quite important, as it is quite common, indeed standard practice, for a class action complaint to allege that managerial defendants, such as board members, had a personal financial interest in an inflated stock price during the class period as a result of insider sales that occurred during this period and the value of management stock options that were exercised. Of course, an unconstrained deployment of this language is not foreordained. Whether this language undermines the official *Tellabs* pleading requirement will ultimately depend on how district courts interpret the words "can be" a relevant consideration and "may" weigh heavily in favor of a scienter inference. This is likely to be an important source of contention between plaintiffs and defendants in future litigation.

III. *Stoneridge*: Third Party Liability and Rule 10b-5's Reliance Requirement

Without question, the securities case that has attracted the most attention, concern and comment both in the general financial press as well as among securities practitioners and commentators of the three cases is the *Stoneridge Investments Partners, LLC v. Scientific-Atlantic, Inc.*[22] case from the Supreme Court's 2007 Term. The saga surrounding what position the Solicitor General would take in its Supreme Court brief in the case, and the differences of opinion between a divided SEC commission and the Treasury Department as to what the government's position in the case should be, powerfully attests to the importance of the case. The attention lavished on the case was in fact well-justified. An opinion allowing plaintiffs to proceed on a Rule 10b-5 "scheme" liability theory against firms (Motorola and Scientific-Atlantic) based on those firms entering into allegedly deceptive contracts with a third firm (Charter Communications) designed to inflate reported operating revenues and cash flow at that third firm would have significantly increased the liability exposure of a wide swath of companies. It bears emphasis, in assessing the implications of permitting such a suit to proceed, that neither Motorola nor Scientific-Atlantic "issue[d] any misstatement relied on by the investing public, nor were they under any duty to Charter investors and analysts to disclose financial information useful in evaluating Charter's true financial condition."[23]

While the Court's conclusion that the lawsuit could not proceed against Motorola and Scientific-Atlantic based on Rule 10b-5 was correct, both on legal as well as policy grounds, the doctrinal rationale actually provided by the court for this conclusion was unfortunately quite weak. This failure will undoubtedly lead to unnecessary litigation and uncertainty. Specifically, the Court concluded that the plaintiffs, purchasers of Charter Communications stock, did not "rely" on the alleged deceptive conduct of Motorola and Scientific-Atlantic and hence the suit could not proceed against these two firms as the Rule 105-b "reliance" requirements was unsatisfied. Strikingly, the court provided no discernable reason for why the *Basic Inc. v. Levinson*[24] fraud-on-the-market means of establishing "reliance" did not apply. The plaintiffs had alleged after all that Charter Communication's disclosures, which were disseminated to the market, contained fraudulently inflated operating revenues and cash flow figures; inflated figures that were allegedly the result of the deceptive contracts with Motorola and Scientific-Atlantic.

Instead, the court merely asserted that the link between the alleged deceptive conduct by Motorola and Scientific-Atlantic and the plaintiffs' stock purchases was "too remote,"[25] too "indirect,"[26] and too "attenuated"[27] to establish "reliance" by the plaintiffs on the deceptive conduct. Besides the obvious tension with the *Basic* decision that such an approach to the "reliance" element of Rule 10b-5 represents, the fundamental weakness with this analysis is that merely asserting that the link between the alleged deceptive conduct and the plaintiffs' stock purchases is too tenuous fails to provide any guidance or framework for determining when the link between deceptive conduct and plaintiff stock purchases in future cases will likewise be deemed too tenuous for reliance purposes. The phrases "too remote," too "indirect," and too "attenuated" are legal conclusions rather than legal analysis.

It is true that the Court, besides merely using various synonyms for "indirect" in characterizing the link between the alleged deceptive conduct and the plaintiffs' stock purchases, makes passing reference to the deceptive contracts "[taking] place in the marketplace for goods and services" (given that the contracts concerned the sale of set top cable boxes to Charter by its suppliers, Motorola and Scientific-Atlantic) and "not in the investment sphere."[28] But this is of little use. How the distinction between the "investment sphere" and the "marketplace for goods and services" is to be drawn in future cases is left unexplained. Nor is it clear what the implications would be if the deceptive conduct did occur in the "investment sphere." Does this mean that in such a situation even an "indirect" link between deceptive conduct and plaintiff stock purchases would be consistent with reliance existing for purposes of Rule 10b-5? Or is it that the distinction between "indirect" and "direct" connections between deceptive conduct and plaintiff stock purchases turns on whether the conduct occurs in the "investment sphere"? Or is the fact that the deceptive conduct occurs in the "investment sphere" a factor, although not necessarily dispositive, as to the "directness" of the connection? If so, what are the other factors and how are they to be weighed?

There is still yet another troubling aspect of the Court's reasoning in *Stoneridge* in terms of future cases. The Court explicitly rejected the position that there "must be a specific oral or written statement before there could be liability" but rather simply stated that "[c]onduct itself can be deceptive..."[29] The reason why the suit could not proceed against Motorola and Scientific-Atlantic according to the Court was the failure to satisfy the "reliance" element, *not* that the conduct in question was non-deceptive. But the Court fails to provide any guidance on what type of conduct by non-talking parties, like Motorola and Scientific-Atlantic, will be deemed "deceptive" and hence potentially actionable under Rule 10b-5.

A far preferable route for the Supreme Court to have taken, one that would have provided a far clearer doctrinal framework that would have sensibly built on the Court's earlier analysis in *Central Bank of Denver* v. *First Interstate Bank*,[30] would have been to conclude that the conduct by Motorola and Scientific-Atlantic was simply not "deceptive" within the meaning of Rule 10b-5. The Court had concluded in *Central Bank* after all that there was no "aiding and abetting" liability in private Rule 10b-5 class action litigation.[31] It would have been easy to conclude that plaintiffs' "scheme" liability theory was in fact just a semantic repackaging of an aiding and abetting theory. That is, plaintiffs' real complaint was that Motorola and Scientific-Atlantic aided and abetted Charter's misleading financial disclosures which resulted in plaintiffs purchasing Charter shares at inflated prices. Such an approach was taken by the Fifth Circuit in a case in which plaintiffs attempted to bring a Rule 10b-5 class action against various banks that allegedly entered into transactions with Enron that enabled Enron to disseminate misleading financial reports resulting in an inflated price for Enron shares.[32] The Fifth Circuit carefully explained the contours of "deceptive" conduct for purposes of Rule 10b-5, after which it concluded that the conduct of the banks in question simply did not constitute "deceptive" conduct under Rule 10b-5. Interestingly, the Supreme Court refused the petition for certiorari seeking review of the Fifth Circuit's opinion one week after it issued the *Stoneridge* opinion, despite the fact that it was at least arguable that some of the bank transactions with Enron were in the "investment sphere."

Endnotes

1 544 U.S. 356 (2005).

2 551 U.S. __ (2007).

3 552 U.S. ___ (2008).

4 *See* Jennifer Bethel, Allen Ferrell & Gang Hu, "Legal and Economic Issues in Subprime Litigation" at Table I, *forthcoming* Brookings volume on the subprime crisis.

5 544 U.S. 356.

6 *See* Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10B-5 Causes of Action: The Implications of Dura Pharmaceuticals v. Broudo*, 63 Business Lawyer 163 (2007)

7 *See, e.g.,* the Second Circuit's 1987 opinion in *Ackerman v. Oryx Communications, Inc.*, 810 F.2d 336.

8 Metzler Inv. GMBH v. Corinthian Colleges, Inc., No. 06-55826.

9 In re Apollo Group, Inc. Securities Litigation*,* 04-CV-2147-PHX-JAT (August 4, 2008).

10 Thorsen, Kaplan, & Hakala, *Rediscovering the Economics of Loss Causation*, 6 Bus. & Sec. L. 93.

11 245 F.R.D 560 (N.D. Tex. 2007).

12 The Enron ERISA litigation settled for some $85 million.

13 29 U.S.C. 1109 (2000) (emphasis added).

14 551 U.S. __ (2007).

15 15 U.S.C. section 78u-4(b)(2) (emphases added).

16 551 U.S. at __.

17 551 U.S. ___, n.4.

18 ACA Financial Guaranty Corp. v. Advest, Inc., 512 F.3d 46 (1st Cir. 2008).

19 Mississippi Public Employees' Retirement System v. Boston Scientific Corp., 2008 WL 1735390 (April 16, 2008).

20 *See* Bay Harbour Management LLC v. Carothers, No. 07-1124-CV (June 24, 2008).

21 551 U.S __.

22 552 U.S. ___.

23 In re Charter Comm. Sec. Litig., 443 F.3d 987, 992 (8th Cir. 2006).

24 485 U.S. 224 (1988).

25 (Slip. Op. at pp. 8, 10).

26 (Slip. Op. at p.8).

27 (Slip. Op. at p.11).

28 (Slip. Op. at 16).

29 (Slip. Op. at 7).

30 511 U.S. 164 (1994).

31 *Central Bank*, 511 U.S. at 177.

32 Regents of Univ. of Cal. v. Credit Suisse First Boston, 482 F.3d 372 (2007).