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## Securities Fraud: Dura Pharmaceuticals, Inc. v. Broudo

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### Summary

On June 28, 2004, the United States Supreme Court granted certiorari in the case *Dura Pharmaceuticals, Inc. v. Broudo*, appealed from the United States Court of Appeals for the Ninth Circuit.

The case concerns allegedly false statements made by Dura to its shareholders concerning development and marketing of two of its products: an asthma inhaler and asthma antibiotic. Plaintiffs charge that the company knowingly defrauded investors by making overly optimistic statements about product approval and company earnings.

The district court held that plaintiffs had not satisfied the requirements for bringing an antifraud case under section 10(b) of the Securities Exchange Act of 1934. The court of appeals stated that the district court erred in applying the federal law for pleading a securities fraud case and reversed and remanded the judgment of the district court. The United States Supreme Court heard oral argument on January 12, 2005.

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Defendant Dura Pharmaceuticals is a publicly traded company which develops and markets prescription pharmaceuticals for treating allergies and asthma. Plaintiffs are investors who purchased Dura stock between April 15, 1997, and February 24, 1998. During this period Dura made statements about two products which it developed and sold: 1. Albuterol Spiros, a mechanical inhaler administering asthma medication and 2. Ceclor CD, an asthma antibiotic. Despite experiencing problems with the development of the inhaler and despite experiencing declines in sales of Ceclor, Dura released a number of optimistic public statements. During the period in question, Dura's stock reached a high of \$53 per share. On February 24, 1998, Dura stated that it expected lower

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<sup>1</sup> No. 03-932.

<sup>2</sup> *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9<sup>th</sup> Cir. 2003).

than forecast 1998 revenues and earnings per share because of, among other reasons, inhaler cost overruns and slower than anticipated sales of Ceclor CD. Dura's stock dropped 47% the next day, and its business declined during the remainder of 1998.

Also, during the time period Dura executives sold approximately \$400 million of personally held Dura stock. Plaintiffs claim that these actions were insider trading and proved that Dura knowingly misrepresented the state of its business to investors.

Plaintiffs brought their suit under section 10(b) of the Securities Exchange Act of 1934.<sup>3</sup> This provision states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

The United States District Court for the Southern District of California<sup>4</sup> initially dismissed the case without prejudice on the basis that plaintiffs had not stated a claim of securities fraud because they did not explain why the statements made were false when made or why the defendants had a duty to disclose. Plaintiffs subsequently filed a Second Amended Complaint (SAC), which was dismissed by the federal district court with prejudice, stating:

The SAC does not contain any allegations that the FDA's non-approval [of the Albuterol Spiros device] had any relationship to the February price drop. Accordingly, the SAC does not explain how the alleged misrepresentations and omissions regarding Albuterol Spiros "touched" upon the reasons for the decline in Dura's stock price. Rather, the decline in Dura's stock price was the result of an expected revenue shortfall. Accordingly the SAC's allegations regarding Albuterol Spiros are insufficient to state a claim.<sup>5</sup>

Plaintiffs appealed.

The Court of Appeals for the Ninth Circuit began its discussion by stating that it has been held that for plaintiffs properly to allege a violation of section 10(b), they must satisfy the following requirements: 1. defendants made a false statement or omission with regard to a material fact; 2. in connection with the purchase or sale of a security; 3. with

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<sup>3</sup> 15 U.S.C. § 78j(b).

<sup>4</sup> 2000 WL 33176043.

<sup>5</sup> 339 F.3d 933, 937.

scienter (knowledge); 4. upon which plaintiffs reasonably relied; and 5. that proximately caused the alleged loss.<sup>6</sup>

The Court of Appeals addressed first the issue of loss causation. The court stated that in the Ninth Circuit loss causation is satisfied when the plaintiff shows that the “misrepresentation touches upon the reasons for the investment’s decline in value.”<sup>7</sup> The court went on to summarize cases that had held that “[i]n a fraud-on-the-market<sup>8</sup> case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.”<sup>9</sup> The court believed that in this case plaintiffs satisfied the requirements of loss causation:

Appellants have pled that the price of the stock was overvalued in part due to the misrepresentations by Dura and the individual defendants that the development and testing of the Albuterol Spiros device were proceeding satisfactorily and that FDA approval of the device was imminent. Accordingly, the district court erred by finding that appellants failed to plead loss causation sufficient to survive a motion to dismiss with regard to statements concerning the Albuterol Spiros device.<sup>10</sup>

The court next addressed the scienter issue and stated that it had to decide whether the plaintiffs had met the scienter requirement concerning their allegations about Dura’s Ceclor sales. The Private Securities Litigation Reform Act<sup>11</sup> sets forth the pleading requirements for securities fraud actions. The complaint must “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”<sup>12</sup> The plaintiff is required to plead “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”<sup>13</sup> The Ninth Circuit had summarized the scienter requirement as follows: “The complaint must allege that the defendant made false or misleading statements either intentionally or with deliberate recklessness or, if the challenged representation is a forward looking statement, with ‘actual knowledge...that the statement was false or misleading.’”<sup>14</sup>

The Ninth Circuit Court of Appeals noted that the district court had considered separately plaintiffs’ arguments that Dura had made false or misleading statements about its products and sales and that Dura’s awareness of the inaccuracy of these statements was evidenced by such actions as sales by executives of their stock. In its consideration

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<sup>6</sup> See *Binder v. Gillespie*, 184 F.3d 1059, 1063 (9<sup>th</sup> Cir. 1999).

<sup>7</sup> *McGonigle v. Combs*, 968 F.2d 810, 821 (9<sup>th</sup> Cir. 1992).

<sup>8</sup> Fraud on the market occurs when a plaintiff can show that he was entitled to rely on the integrity of the market price for securities bought or sold.

<sup>9</sup> See, e.g., *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9<sup>th</sup> Cir. 1996).

<sup>10</sup> 339 F.3d 933, 939.

<sup>11</sup> P.L. 104-67, 109 Stat. 737 (1995).

<sup>12</sup> 15 U.S.C. § 78u-4(b)(1).

<sup>13</sup> 15 U.S.C. § 78u-4(b)(2).

<sup>14</sup> *In re Vantive Corporation Securities Litigation*, 283 F.3d 1079 (9<sup>th</sup> Cir. 2002).

separately of plaintiffs' allegations, the district court had concluded that each was insufficient to show scienter. The court of appeals stated that it had made clear that allegations of scienter must be considered separately:

Beyond each individual allegation we also consider "whether the total of plaintiffs' allegations, even though individually lacking, are sufficient to create a strong inference that defendants acted with deliberate or conscious recklessness."<sup>15</sup>

The court of appeals vacated the district court's finding of no scienter and instructed the district court on remand to consider collectively the allegations.

Finally, the court of appeals considered the argument that plaintiffs should have been able to amend the Second Amended Complaint. The court of appeals stated that leave to amend under Rule 15 of the Federal Rules of Civil Procedure should be liberally applied. In looking at various statements that plaintiffs wished to include in an amended complaint, the court of appeals stated that, "[b]ecause it appears that Appellants had a reasonable chance of successfully stating a claim if given another opportunity, the district court abused its discretion in denying leave to amend the SAC."<sup>16</sup> The court of appeals therefore reversed and remanded the judgment of the district court.

On January 12, 2005, the United States Supreme Court heard oral argument. The wording of the question presented to the Court as filed in the briefs by petitioners and respondents varies somewhat. Petitioners state that the question presented is whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price. Respondents state the question as whether to plead loss causation in a section 10(b) open-market fraud case plaintiffs must do more than plead facts establishing fraud-based inflation and overpayment on the date of their purchase.

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<sup>15</sup> No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corporation, 320 F.3d 920, 938 (9<sup>th</sup> Cir. 2003) (*quoting* Lipton v. Pathogenesis Corporation, 284 F.3d 1027, 1038 (9<sup>th</sup> Cir. 2002).

<sup>16</sup> 339 F.3d 933, 941.