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### Securities Litigation E-Alert: The Fifth Circuit and Loss Causation

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The Fifth Circuit continues to give teeth to the “loss causation” doctrine as a defense to securities class actions. On September 8, 2008, it affirmed the dismissal of an options backdating lawsuit on loss causation grounds. *Catogas v. Cyberonics, Inc.*, 2008 WL 4158923 (5th Cir. Sept. 8, 2008). The court’s opinion is unpublished, but it is noteworthy for two reasons: (1) the district court had dismissed the complaint for lack of scienter, but the Fifth Circuit ignored this more traditional basis for dismissal and instead reached out to address the loss causation issue; and (2) the Fifth Circuit rejected plaintiffs’ loss causation theory at the pleading stage, despite the fact that the company’s stock price sharply declined on the date of the alleged corrective disclosure.

#### The Loss Causation Doctrine

Loss causation has been a hot issue in securities litigation since the Supreme Court’s decision two years ago in *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005), and this is especially true in the Fifth Circuit. This is hardly surprising, since it was the Fifth Circuit that effectively created the doctrine in 1981. In *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *rev’d on other grounds*, 459 U.S. 375 (1983), the Fifth Circuit held that loss causation was an essential element of a claim under section 10(b). The loss causation requirement is met “only if the misrepresentation touches upon the reasons for the investment’s decline in value.”

Other courts, including the Ninth Circuit, subsequently adopted a more lenient approach to loss causation. Those courts concluded that loss causation could be established merely by showing that the plaintiffs paid an inflated price for their shares, regardless of whether the alleged fraud actually caused a stock price decline. For years, therefore, there was a conflict among the circuits on this critical issue.

#### Dura Pharmaceuticals

Twenty-five years after *Huddleston*, the Supreme Court finally addressed loss causation in the *Dura* case. In *Dura*, the Supreme Court reviewed a Ninth Circuit decision holding that loss causation was satisfied if the plaintiff could prove that “the price at the time of purchase was inflated because of the misrepresentation.” In a unanimous decision authored by Justice Breyer, the Supreme Court rejected the Ninth Circuit’s price inflation theory of loss causation. Instead, the court held that a plaintiff must prove that there was a causal connection between the alleged misrepresentations and the subsequent decline in the stock price.

The Supreme Court explained that “as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value.” Moreover, the court explained, “the logical link between the inflated share purchase price and any later economic loss is not invariably strong.” A subsequent resale of the stock at a lower price may result from “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 *Dura* clearly rejected the price inflation theory of loss causation, it failed to provide guidance on an important issue: Must there be a corrective disclosure that reveals the “truth” to the market, followed by a consequent decline in the stock’s price? The Supreme Court stated that a plaintiff must “prove that the defendant’s misrepresentations (or other fraudulent conduct) proximately caused the plaintiff’s loss,” but it did not address whether the plaintiff is required to tie his loss to a specific corrective disclosure.

At least in the Fifth Circuit, this issue has been resolved.

#### *Catogas v. Cyberonics*

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In *Cyberonics*, the Fifth Circuit held that loss causation requires proof of a “corrective disclosure” that causes a decline in the company’s stock price. This is a significant hurdle, and in light of the facts of *Cyberonics*, it is apparent that it will be strictly construed.

The *Cyberonics* complaint made two principal claims: (1) allegations that the company had made false and misleading statements regarding the likelihood that the FDA would approve a new device for the treatment of depression; and (2) allegations that the company had improperly backdated stock option grants over a four-year period. Plaintiffs’ appeal was limited to the dismissal of the stock options claim.

Plaintiffs’ allegations had substance. *Cyberonics* itself concluded that it had inappropriately accounted for stock option grants, and its CEO was forced to step down. The company issued a series of announcements stating that it was conducting an internal investigation, that its financial statements would be delayed, and that it was facing SEC and U.S. Attorney inquiries, among other disclosures.

Ultimately, on August 1, 2006, the company announced that it had received a letter from NASDAQ advising that *Cyberonics* was subject to delisting from the NASDAQ Global Market. The company’s share price dropped 25% after the announcement. Plaintiffs argued that the August 1st press release caused the stock price decline, and further, that the press release “constitute[d] a corrective disclosure because the release was ‘the first time that the market learned the full ramifications of the backdating and re-pricing scheme.’”

The Fifth Circuit disagreed, pointing to the company’s prior press releases concerning its internal investigation and delayed financial statements. The court held that “although the stock price dropped dramatically on the day of the August 1, 2006 press release, no new facts concerning *Cyberonics*’ stock-option accounting were disclosed in that release which demonstrated that the ‘truth became known’ about *Cyberonics*’ challenged financial statements.” Therefore, the Fifth Circuit concluded that “a causal connection between the material misrepresentations and the loss was not adequately pled.”

According to the Fifth Circuit, the only “new” news in the August 1st press release concerned the NASDAQ de-listing. While the de-listing was a consequence of the defendants’ alleged fraud, it was not a “corrective disclosure” that revealed the truth. Finding that plaintiffs had failed to tie the August 1st announcement to a corrective disclosure, the court affirmed the dismissal of the complaint.

### Pleading Standard

One unresolved question involves the applicable pleading standard for loss causation. Must a plaintiff’s loss causation allegations satisfy the heightened pleading requirements of Fed. R. Civ. P. 9(b)? In *Dura*, the Supreme Court assumed “at least for argument’s sake” that the notice pleading requirements of Fed. R. Civ. P. 8(a)(2) applied to the pleading of loss causation, as opposed to the more stringent pleading requirements of Rule 9(b). Following *Dura*’s lead, most lower courts to address the issue have concluded that loss causation allegations are not subject to the particularity requirements of Rule 9(b).

By contrast, the Fifth Circuit seems to have adopted a more stringent pleading standard. The *Cyberonics* decision does not address Rule 9(b) directly, but it holds that “plaintiffs failed to plead loss causation *with the requisite particularity*.” This language comes directly from Rule 9(b), and it is consistent with the court’s clear-eyed scrutiny of the plaintiffs’ allegations.

Regardless of which pleading standard applies, it is clear that the Fifth Circuit intends to carefully examine loss causation allegations and dismiss those it finds wanting. Even for those claims that survive, the plaintiff’s victory may prove short-lived. Loss-causation allegations face an even more rigorous examination at the class certification stage. See *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (5th Cir. 2007). In the Fifth Circuit, loss causation is a powerful defense that can be employed at virtually every stage of a proceeding -- pleading, certification, summary judgment, and trial. It is an essential part of a defense lawyer’s arsenal and its importance is only growing.