FORGIVE AND FORGET (THE EFFICIENT AMNESIAC): LOSS CAUSATION IN A WELL-DEVELOPED POST *DURA* MARKET

IAN ACKERMAN[*]

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In April of 2005, the Supreme Court of the United States published its opinion on *Dura Pharmaceuticals, Inc. v. Broudo*.[1] *Dura Pharmaceuticals* was a securities fraud class action suit brought under section 10(b) of the Securities Exchange Act of 1934[2] and Rule 10b-5[3] promulgated there under.[4] The Supreme Court granted certiorari to consider the Ninth Circuit's conclusion that the plaintiffs had sufficiently alleged the necessary element of loss causation to state a claim against the defendants.[5] Reversing the Ninth Circuit, Justice Breyer, writing for the majority, declared, "[n]ormally . . . an inflated purchase price will not itself constitute or proximately cause the relevant economic loss" in fraud-on-the-market cases.[6] This note explores the soundness of the decision handed down by the Court in light of prior Supreme Court opinions regarding private Rule 10b-5 actions, as well as the consequences of

[*] Student, Boston University School of Law (J.D. 2006).
[1] Dura Pharmaceuticals, Inc. v. Broudo, 125 S. Ct. 1627 (2005).
[2] 15 U.S.C. § 78j(b) (2000).
[3] 17 C.F.R. § 240.10b-5 (2004).
[4] *Dura Pharm.*, 125 S. Ct. at 1630-31.
[5] *Id.* at 1630.
[6] *Id.* at 1631.

a new loss causation rule, given the specific controversy at issue and guidance from the opinion.

I. Background

As early as 1946, federal courts began entertaining a judicially implied private civil action for deceptive and manipulative securities practices that violated section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.[7] Over the years, the basic elements of the private suit were clarified as landmark decisions addressed key disagreements over how the law should be applied to effectuate its purpose.[8] Congress ultimately affirmed decades of acquiescence to judicial precedent in the Private Securities Litigation Reform Act of 1995 ("PSLRA") which accepted the private cause of action while interjecting on the prima facie elements that had been adopted by the courts.[9]

A prima facie, private 10b-5 securities fraud claim based on a defendant's untrue statement, or omission of facts necessary to render a prior statement not misleading, must establish that: (1) the defendant's misstatement or omission was material;[10] (2) the fraud occurred in connection with the purchase or sale of a security;[11] (3) the defendant acted with scienter;[12] (4) the plaintiff relied on the misstatement or omission;[13] and (5) the misstatement or omission actually caused the plaintiff's loss.[14] The meaning of the last

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[7] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729-30 (1975); *See also Dura Pharm*, 125 S. Ct. at 1630-31; Basic, Inc. v. Levinson, 485 U.S. 224, 230-31 (1988).

[8] *See, e.g., Basic, Inc.*, 485 U.S. 224; Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); *Blue Chip Stamps*, 421 U.S. 723; Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972).

[9] *See* 15 U.S.C. § 78u-4 (2000).

[10] *Basic, Inc.*, 485 U.S. at 231-232. A misstatement or omission is material "'if there is a substantial likelihood that a reasonable [investor] would consider [the facts] important'" to his or her decision to buy or sell the security. *Id.* (citations omitted).

[11] *Blue Chip Stamps*, 421 U.S. at 730-731.

[12] Scienter is a "wrongful state of mind." Dura Pharmaceuticals, Inc. v. Broudo, 125 S. Ct. 1631 (2005). Therefore, a successful claim requires that the fraudster's act is more than merely negligent. *See Ernst & Ernst*, 425 U.S. *passim*; *Dura Pharm.*, 125 S. Ct. at 1627, 1631.

[13] *Basic, Inc.*, 485 U.S. at 243. Because "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury," public misstatements relating to securities on a well-developed market ("fraud-on-the-market") give rise to a rebuttable presumption of reliance. *Id.* at 243, 247-49.

[14] 15 U.S.C. § 78u-4(b)(4) (2000); *Dura Pharm.*, 125 S. Ct. at 1631.

element was the focus of the Supreme Court's decision in *Dura Pharmaceuticals*.

The securities fraud dispute in *Dura Pharmaceuticals* began with the filing of a complaint by a plaintiff class of individual investors who purchased shares of stock in Dura Pharmaceuticals, Inc. "between April 15, 1997 and February 24, 1998."[15] The complaint accused the corporation and its officers (hereinafter "Dura") of making certain false public statements during the class period that resulted in the artificial inflation of the price of Dura's stock above its true value, and thereby financially injured the plaintiffs.[16] Specifically, the plaintiffs focused on a series of press releases issued by Dura reporting positive sales of Ceclor CD, a respiratory antibiotic, as well as untenable optimism regarding the development and testing progress of Albuterol Spiros, a new asthma medication spray-delivery system.[17]

On the last day of the class period, Dura's stock dropped from $39 to $21 per share (more than a 47 percent decline) upon the firm's announcement that earnings would not meet company expectations, primarily due to poor drug sales involving Ceclor CD.[18] Eight months after the Ceclor CD correction, Dura publicly disclosed that its Spiros system failed to receive FDA approval.[19] Again the market responded with a price decline, but this time the stock price recovered almost entirely within a week.[20]

Plaintiffs subsequently brought their class action suit in federal district court claiming that Dura's statements caused plaintiffs' injury and violated federal securities laws.[21] After an initial dismissal without prejudice, the district court dismissed the plaintiffs' amended complaint with prejudice.[22] The district court found that the plaintiffs failed to plead with sufficient particularity that Dura acted with the necessary state of mind, *i.e.*, scienter, concerning its optimistic Ceclor CD sales reports.[23] With regard to the Spiros asthma spray statements, the district court dismissed the

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[15] *Dura Pharm.*, 125 S. Ct. at 1629.
[16] *Id.* at 1630.
[17] *See* Broudo v. Dura Pharmaceuticals, Inc., 339 F.3d 933, 935 (9th Cir. 2003).
[18] *Dura Pharm.*, 125 S. Ct. at 1630.
[19] *Id.*; *Broudo*, 339 F.3d at 936.
[20] *Dura Pharm.*, 125 S. Ct. at 1630.
[21] *Id.* at 1629.
[22] *Id.* at 1630; *Broudo* 339 F.3d at 936-37.
[23] *Dura Pharm.*, 125 S. Ct. at 1630; *Broudo*, 339 F.3d at 937.

complaint for failure to adequately plead loss causation.[24] Because Dura had not made any corrective statements about the Spiros device prior to the February 24 stock drop, the district court reasoned, "any omissions or misleading statements about this device could not be said to have caused the decline in price," and therefore concluded that the statements made by Dura did not cause the loss necessary to sustain an action under 10b-5.[25]

Although the Ninth Circuit reversed the district court's handling of both the Ceclor CD and Spiros statements,[26] the Supreme Court reconsidered only the circuit court's analysis of loss causation in securities fraud actions based on 10(b) and 10b-5.[27] Specifically, the Ninth Circuit instructed that "[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price *on the date of purchase* was inflated because of the misrepresentation."[28] "Accordingly," the court explained, "for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the transaction."[29] Therefore, pleading loss causation in the Ninth Circuit required no more than claiming an overstated purchase price and sufficient identification of the misstatement or omission alleged to be the cause.[30] Based on this standard, the Ninth Circuit found that the plaintiffs' complaint sufficiently established the element of loss causation to withstand a motion to dismiss.[31]

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[24] *Dura Pharm.*, 125 S. Ct. at 1630.
[25] *Broudo*, 339 F.3d at 937.
[26] *Id.* at 941.
[27] *Dura Pharm.* 125 S. Ct. at 1630.
[28] *Broudo*, 339 F.3d at 938 (alteration in original) (quoting Knapp v. Earnst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996)).
[29] *Id.* (citations omitted).
[30] *Id.*
[31] The Ninth Circuit found that the loss causation requirement was satisfied where the complaint alleged "the price of the stock was overvalued in part due to 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," thereby making the alleged purchase price overvaluation and its corresponding cause known to the defense. *Id.* at 939.

II. Supreme Court Rejects the Ninth Circuit Analysis of Loss Causation

In *Dura Pharmaceuticals*, the Supreme Court rejected the Ninth Circuit's loss causation analysis.[32] First, the Court disagreed with the Ninth Circuit's conclusion as to what must be disclose proven to satisfy the loss causation requirement of a private 10b-5 action.[33] Second, the Court disagreed with the Ninth Circuit about what a complaint must allege to survive to the discovery phase of the litigation.[34] Specifically, the Court found that the plaintiffs' allegations failed to satisfy even the minimal notice pleading requirements laid out by Rule 8 of the Federal Rules of Civil Procedure.[35] Justice Breyer noted several insufficiencies in the Ninth Circuit's loss causation analysis.

A. Ninth Circuit Analysis lacks Precedent

Justice Breyer's opinion criticizes the Ninth Circuit's analysis of loss causation for a lack of "support in precedent."[36] The Court attempts to draw support to discredit the court of appeals' holding by analogizing the 10b-5 securities fraud action with common law misrepresentation and deceit claims.[37] Due to the judicially implied nature and development of private securities actions, the opinion suggests that these common law actions serve as relevant precedent for analyzing loss causation.[38] Under the precedent cited by the Court, it is clear that a plaintiff must establish that the defendant's misrepresentation or deception caused the plaintiff's injury in order to prevail on a fraud claim.[39]

Citing several treatises on the relevant common law, the Court mused that "damage 'must already have been suffered before the bringing of the suit'";[40] "plaintiff must show that he 'suffered

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[32] *Dura Pharm.*, 125 S. Ct. at 1629.
[33] *Id.* at 1631.
[34] *Id.* at 1634.
[35] *Id.* (citations omitted).
[36] *Id.* at 1632.
[37] *See Id.* at 1632-33.
[38] *See Id.* at 1632.
[39] *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 525 (1977); Southern Development Co. of Nevada v. Silva, 125 U.S. 247, 250 (1888).
[40] *Dura Pharm.*, 125 S. Ct. at 1632 (quoting M. BIGELOW, LAW OF TORTS 101 (8th ed. 1907)).

damage' and that the 'damage followed proximately the deception'";[41] "plaintiff 'must have suffered substantial damage,' not simply nominal damages, before 'the cause of action can arise.'"[42] Certainly the Court broke no new ground in suggesting that plaintiffs must suffer actual damages to succeed in a 10b-5 action. Despite a difference of opinion on the means and intricacies for proving plaintiffs' losses, circuit courts diligently executed the loss causation requirement in securities fraud claims long before the Court's decision in *Dura Pharmaceuticals*.[43] Likewise, it's hardly a novel statement for the Court to imply a relationship between 10b-5 and common law.[44]

The common law principles dispensed by the Court offer little insight into what the tribunal should require from the plaintiffs who must prove they were damaged by a defendant's fraud. The common law doctrine assembled by the Court simply begs the question, and fails to clarify what the plaintiffs' relevant injuries might be or when they actually occur in a securities fraud-on-the-market scenario. Consequently, these guidelines seem a less-than-convincing justification for interfering in the Ninth Circuit approach to loss causation, and at best they offer little insight as a guiding precedent. The Court does provide one excerpt from the Restatement (Second) of Torts' "judicial consensus" that relates more directly to the relevant question: "a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains 'when the facts . . . become generally known' and 'as a result' share value 'depreciate[s].'"[45]

In this regard, however, it is perhaps significant that the Court in *Dura Pharmaceuticals* failed to address previously

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[41] *Id.* (quoting 2 T. COOLEY, LAW OF TORTS § 348, at 551 (4th ed. 1932)).

[42] *Id.* (quoting W. KEETON, D. DOBBS, R. KEETON, & D. OWEN, PROSSER AND KEETON ON LAW OF TORTS § 110, at 765 (5th ed. 1984)).

[43] *See, e.g.*, Broudo v. Dura Pharmaceuticals, Inc., 339 F.3d 933, 937-39 (9th Cir. 2003); Gebhardt v. Conagra Foods, Inc., 335 F.3d 824, 831-32 (8th Cir. 2003); Suez Equity Investors v. Toronto-Dominion Bank, 250 F.3d 87, 96-98 (2d Cir. 2001); Semerenko v. Cendant Corp., 223 F.3d 165, 183-87 (3d Cir. 2000); Robbins v. Koger Properties, Inc., 116 F.3d 1441, 1447-49 (11th Cir. 1997); Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965).

[44] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744 (1975); Basic, Inc. v. Levinson, 485 U.S. 224, 243-244 (1988).

[45] *Dura Pharm.*, 125 S. Ct. at 1633 (quoting RESTATEMENT (SECOND) OF TORTS § 548A, cmt. b, at 107 (1977)) (alteration in original).

proposed distinctions between the modern securities fraud action and its common law cousins. In preceding decisions, the Court has been more careful to note the historical divergence of regulations implemented to protect the interests of a modern securities markets from those developed at common law.[46] Indeed, in the landmark case of *Blue Chip Stamps*, the Court noted the current market is one where "privity of dealing or even personal contact between potential defendant and potential plaintiff is the exception and not the rule."[47] "The typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable."[48] In *Basic Inc.*, another cornerstone of 10b-5 jurisprudence, the Court pointed out that Rule 10b-5 is not merely a derivative of common law fraud actions, but is "in part designed to add to the protections provided investors by the common law."[49] Likewise, the Court has noted Congressional intent for the Securities Exchange Act of 1934 to replace '"the philosophy of caveat emptor . . . [with] a high standard of business ethics in the securities industry," requiring a flexible construction of the law "to effectuate its remedial purposes."'[50]

Considering the shortage of clear guidance from principles of common law misrepresentation and deceit actions, and the Court's previous acknowledgement of the special purpose of securities regulations, Justice Breyer's chiding of the Ninth Circuit for lack of common law "precedent" is a less than persuasive basis for striking down the loss causation analysis applied there.

B. Ninth Circuit View is an Island

The Supreme Court further bolsters its decision to reverse the court of appeals by pointing to the "uniqueness of [the circuit court's] perspective" on loss causation compared to other circuits.[51] The Court is troubled that it "cannot reconcile the Ninth Circuit's 'inflated purchase price' approach with [the] views of other

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[46] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (citations omitted).
[47] *Blue Chip Stamps*, 421 U.S. at 745.
[48] *Id.* at 744-45.
[49] *Basic, Inc.*, 485 U.S. at 244 n.22 (citing *Blue Chip Stamps*, 421 U.S. at 744-45; Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983)).
[50] *Affiliated Ute*, 406 U.S. at 151 (citations omitted).
[51] Dura Pharmaceuticals, Inc. v. Broudo, 125 S. Ct. 1627, 1633 (2005).

courts."[52] In support of this proposition, the Court cites Second, Third, Seventh, and Eleventh Circuit precedent on establishing loss causation.[53] Additionally, Fourth Circuit precedent, though not as precise, would likely merge neatly with the counter-examples presented by the Court.[54] Certainly, the Court's examples of alternative interpretations on loss causation appear to require more than the Ninth Circuit's inflated purchase price approach.[55]

Notwithstanding the more restrictive tests for loss causation required in a handful of circuits, the Court's collection of examples hardly establishes the "uniqueness" alleged to discredit the Ninth Circuit's analysis. As it turns out, the Ninth Circuit is not entirely alone among the circuits to permit proof of loss causation in situations similar to those in *Dura Pharmaceuticals*. The Eighth Circuit, at least, has clearly accepted a similar examination. In *Gebhardt v. Conagra Foods, Inc.*, the Eighth Circuit explained that loss causation may be proven where the plaintiff simply pays "more for something than its worth" in a fraud-on-the-market case.[56] The *Gebhardt* court clarified that the circuit would not attach "dispositive significance to the stock's price movements absent sufficient facts and expert testimony," even though the defendant's stock price actually rose following the defendant's corrective disclosures.[57]

Similarly, although the Fifth Circuit didn't address the scenario directly, dictum suggests the court of appeals would recognize that loss causation was satisfied where "the misrepresentation touches upon the reasons for the investment's decline in value,"[58]–exactly the same language used by the Ninth Circuit in this case.[59] Granted, however, this does not prove that the

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[52] *See id.*

[53] *See id.* at 1632-33 (citing Emergent Capital Investment 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 Properties, Inc., 116 F.3d 1441, 1448 (11th Cir. 1997); Bastian v. Petren Resources Corp., 892 F.2d 680, 685 (7th Cir. 1990).

[54] *Cf.* Miller v. Asensio & Co., Inc., 364 F.3d 223, 232 (4th Cir. 2004) (requiring proof of impact of defendant's fraud to recover out-of-pocket damages).

[55] *See Emergent Capital*, 343 F.3d at 197-98; *Semerenko*, 223 F.3d at 184-85; *Robbins*, 116 F.3d at 1448; *Bastian*, 892 F.2d at 685.

[56] Gebhardt v. Conagra Foods, Inc., 335 F.3d 824, 831-32 (8th Cir. 2003).

[57] *Id* at 832.

[58] Nathenson v. Zonagen, Inc., 267 F.3d 400, 413 n.10 (5th Cir. 2001) (quoting Abell v. Potomac Ins. Co., 858 F.2d 1104, 1117 (5th Cir. 1988) (*vacated on other grounds*, Fryar v. Abell, 492 U.S. 914 (1989)).

[59] Broudo v. Dura Pharmaceuticals, Inc., 339 F.3d 933, 937-38 (9th Cir. 2003).

Fifth Circuit would apply the loss causation element exactly as the Eighth and Ninth Circuits. While the Ninth Circuit's perspective might be in the minority among those that have faced similar questions, it also turns out to be less unique than the Supreme Court maintains. Therefore, as a basis for the Supreme Court's *Dura Pharmaceuticals* decision, "the uniqueness of [the Ninth Circuit's] perspective" is not a very convincing reason to reverse the lower court.

C. Ninth Circuit Analysis is Inconsistent with Securities Regulation Objectives

In *Dura Pharmaceuticals*, the Supreme Court finds the Ninth Circuit loss causation analysis inconsistent with the policy objectives of the federal securities regulation scheme.[60] To criticize the lower court's holding, the Supreme Court points out that although private securities fraud claims have been recognized to help "maintain public confidence in the marketplace," they are intended not to serve as "broad insurance against market losses, but to protect [investors] against those economic losses that misrepresentations actually cause."[61] The Court bolsters this point by reference to the PSLRA of 1995.

The PSLRA addressed the private cause of action under 10(b) that courts already implied for decades.[62] Through the PSLRA, Congress codified specific requirements of a private securities fraud action. Among those requirements, Congress instituted a heightened pleading burden to establish the defendant's requisite state of mind: scienter.[63] The PSLRA requires a plaintiff to list each of the specific misstatements alleged in the suit, as well as the basis for concluding that the misstatements are misleading, or else the court must dismiss the case on a motion by the defendant.[64] Furthermore, the PSLRA expressly burdens the plaintiff with the obligation to prove that the defendant's misstatements or omissions

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[60] Dura Pharmaceuticals, Inc. v. Broudo, 125 S. Ct. 1627, 1633 (2005).
[61] *Id.* (quoting United States v. O'Hagan, 521 U.S. 642, 658 (1997); Basic, Inc. v. Levinson, 485 U.S. 224, 252 (1988) (White, J., joined by O'Conner, J., concurring in part and dissenting in part)).
[62] *See* 15 U.S.C. § 78u-4 (2000).
[63] 15 U.S.C. § 78u-4(b)(2) (2000).
[64] 15 U.S.C. §§ 78u-4(b)(1), (3) (2000).

"caused the loss for which the plaintiff seeks to recover damages."[65] The *Dura Pharmaceuticals* Court points to this Congressional assertion to support its restriction on the Ninth Circuit's loss causation analysis.

Notably, the Court asserts "Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss."[66] By contrast, "the Ninth Circuit's approach would allow recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss."[67] It seems like a reasonable reading of the statutory language to conclude, as the Court does, that Congress merely intended to codify the traditional loss causation or proximate cause requirement long applied by the courts.[68] However, this leaves lower courts where they started: with common-law precedent providing little or no guidance for *how* this should be done. The Supreme Court apparently disagrees. Justice Breyer believes the law is sufficiently clear to conclude that, regardless of how it may be shown generally, the plaintiffs in this case have failed to satisfy their loss causation obligation.[69]

It is well established that the responsibility of the judiciary includes interpreting the acts of Congress to say what the law is; that it may be applied to the many factual scenarios that come before a tribunal.[70] Accordingly, canons of construction have come to provide useful "rules of thumb" to assist the courts with their duty to "determine the meaning of legislation."[71] Premier among these canons is the notion that a court should look first to the language of the statute itself, and where the meaning is clear and unambiguous, the "judicial inquiry is complete."[72] Language, however, is pliable, and the courts have a long history of turning to legislative history to help them ascertain the will of Congress where the meaning is less than clear and unambiguous.[73] But, regardless of the word wrangle

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[65] 15 U.S.C. § 78u-4(b)(4) (2000).
[66] *Dura Pharm.*, 125 S. Ct. at 1633.
[67] *Id.*
[68] *Id.*
[69] *Id.* at 1634.
[70] *See* Marbury v. Madison, 5 U.S. 137, 177 (1803).
[71] Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 253 (1992).
[72] *Id.* at 254 (citations omitted).
[73] *See* Wisconsin Pub. Intervenor v. Mortier, 501 U.S. 597, 611 n.4 (1991) (citation omitted).

facing a court, where legislative history shines light on the question under inspection, "common sense suggests that inquiry benefits from reviewing additional information rather than ignoring it."[74] Even where statutory language might appear on its face to be unambiguous, a court is wise to look to all available information rather than rely on "rote repetition of canons of statutory construction."[75]

When the *Dura Pharmaceuticals* Court declared the Ninth Circuit's loss causation analysis inconsistent with the objectives of federal securities regulation, it pointed to the PSLRA to justify that decision. Addressing the PSLRA was important for producing a defensible opinion because of the 1995 Act's explicit codification of the loss causation element of a 10b-5 suit.[76] By concluding that the Ninth Circuit holding did not require the plaintiff class to prove the defendant caused the plaintiffs' loss, it was easy to find that the Ninth Circuit analysis failed to satisfy the PSLRA requirement that a plaintiff, in fact, must prove the defendant "caused the loss for which the plaintiff seeks to recover."[77] Based on the Court's belief in a strict common law background for private fraud actions, and the fact that Congress imposed heightened pleading requirements on the scienter element of a suit, one could imagine that Congress intended to impose a restrictive loss causation standard on a 10b-5 plaintiff as well. This would be consistent with a general inclination toward limited private actions under 10b-5. Consequently, it would appear that the Ninth Circuit's decision was, indeed, inconsistent with the objectives of federal securities litigation as embodied in the PSLRA.

The Supreme Court's opinion failed, however, to look beyond the statutory language to consider any additional information that might illuminate what Congress intended when it placed the burden on a plaintiff to actually prove the defendant "caused the loss for which the plaintiff seeks to recover."[78] If it had, it is possible that a different conclusion may have prevailed. Interestingly, the House Conference Report provides, as example, that the loss causation requirement of the PSLRA would be satisfied where the plaintiff was able to "prove that the price at which the plaintiff bought the stock

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[74] *See Id.* at 611 n.4.
[75] *See* Koons Buick Pontiac GMC, Inc. v. Nigh, 125 S. Ct. 460, 470 (2004) (Stevens, J., joined by Breyer, J., concurring) (citations omitted).
[76] 15 U.S.C. § 78u-4(b)(4) (2000).
[77] 15 U.S.C. § 78u-4(b)(4) (2000); *See Dura Pharm.*, 125 S. Ct. at 1633.
[78] 15 U.S.C. § 78u-4(b)(4) (2000).

was artificially inflated as the result of the misstatement or omission."[79]

The Conference Report makes no mention of requiring a subsequent drop in price to establish loss causation.[80] Certainly, this would have been a very short and simple statement to append to an example that alleges to satisfy the statute's loss causation requirement. It seems a substantial oversight to omit such a statement if it was the intent of Congress to require, not only that a plaintiff prove payment of an inflated purchase price, but also that the price subsequently dropped upon disclosure of a corrective statement before a plaintiff could prove loss causation. The absence of any language to this effect seems to weigh heavily in favor of a conclusion that Congress did not intend to require the subsequent drop in price before a plaintiff class could prove it had suffered a loss caused by the defendant. If Congress actually did intend to permit a plaintiff to prove loss causation based on inflated purchase price alone, then it seems the Supreme Court was incorrect in asserting that the Ninth Circuit's analysis was inconsistent with the objectives of federal securities regulation.

This alternative analysis, arguably authorized by the House Conference Report, also seems consistent with the other securities regulation objectives the *Dura* Court left unaddressed. In fact, these previously mentioned objectives could be well served by the Ninth Circuit's approach to loss causation. For example, the Ninth Circuit's analysis may be complementary to a policy of construing the federal securities regulation scheme "not technically and restrictively, but flexibly to effectuate its remedial purposes."[81] Certainly, such a holding would encourage a higher "standard of business ethics in the securities industry"[82] by fortifying the more elusive common law fraud prohibitions, another securities regulation goal endorsed by the Supreme Court.[83]

Furthermore, the Ninth Circuit's loss causation analysis doesn't appear to put securities regulations in the category of broad

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[79] H.R. CONF. REP. NO. 104-369 at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.
[80] *See* H.R. CONF. REP. NO. 104-369 at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.
[81] Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (internal quotation marks omitted) (citation omitted).
[82] *Id.* (internal quotation marks omitted) (citation omitted).
[83] *See* Basic, Inc. v. Levinson, 485 U.S. 224, 244 n.22 (1988) (citation omitted).

investment insurance that had troubled the *Dura* court.[84] Although the Ninth Circuit's analysis arguably permits the presumption that a defendant caused the plaintiffs' loss by creating an overstated purchase price, there is no reason to believe that the defendant could not rebut this presumption.[85] Accordingly, the Ninth Circuit's analysis creates no more an investment insurance scheme than the presumption of reliance endorsed in fraud-on-the-market cases by the Supreme Court in *Basic*.[86] This is a far cry from a policy that would reimburse investors for market losses unrelated to the defendant's intentional, material misrepresentations.

Despite the legislative history behind the PSLRA, the Supreme Court never addressed the potential inconsistency between the report of the House Conference Committee and its opinion. Whether by operation of a rule of thumb born from the canons of statutory construction or through simple judicial oversight, the meaning of the legislative history remains a mystery. The opinion specifically states that the Ninth Circuit's analysis of loss causation is incompatible with the dictates of the PSLRA, and therefore, as if a self-fulfilling prophecy, the Ninth Circuit's analysis of loss causation cannot be reconciled with the mandates of Congress.[87] Due to the Circuit's irreconcilable difference with the PSLRA, it undoubtedly "overlooks an important securities law objective."[88]

D. Ninth Circuit Analysis is Illogical

Finally, the *Dura* Court is unsatisfied with the Ninth Circuit's approach to loss causation because that approach is illogical.[89] The Court begins by addressing the foundation of the

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[84] *See* Dura Pharmaceuticals, Inc. v. Broudo, 125 S. Ct. 1627, 1633 (2005) (citation omitted).

[85] In *Dura*, the Court pointed to Justice White's partial concurrence in *Basic* to support the anti-insurance objective of securities regulations. *See Id.* Justice White's opinion suggested that 10b-5 actions would essentially serve as a broad insurance policy for investors if the presumption of reliance in a fraud-on-the-market case was irrefutable. *Basic, Inc.*, 485 U.S. at 252 (White, J., joined by O'Conner, J. concurring in part and dissenting in part). The majority explicitly stated that the presumption was merely a tool of policy and judicial economy that could be rebutted by "any showing that severs the link." *Id.* at 245, 248.

[86] *See Basic, Inc.*, 485 U.S. at 245-246, 248-249; *See also Basic, Inc.*, 485 U.S. at 252 (White, J., joined by O'Conner, J., concurring in part and dissenting in part).

[87] *Dura Pharm.*, 125 S. Ct. at 1633.

[88] *Id.*

[89] *See Id.* at 1631-32.

Ninth Circuit's finding for the adequacy of plaintiffs' complaint, "namely, that . . . plaintiffs need only 'establish,' *i.e.*, prove, that 'the price *on the date of purchase* was inflated because of the misrepresentation.'"[90] Contrariwise, an investor who pays an inflated stock price has a stock of the equivalent value "*at that instant*."[91] An uninformed investor could merely resell his or her stock before any corrective statement is made and innocently transfer the loss to another investor. The inflated purchase price would cause no loss to the plaintiff because the value of the misrepresentation is recovered from the market price at the moment of sale. [92] In such a situation, the inflated purchase price would "not itself constitute or proximately cause [a] relevant economic loss."[93]

On one hand, the Court's assertions seem quite reasonable at first blush. The Court's rationale draws a clear line around a problem with the plaintiffs' class in *Dura* for members who didn't retain their shares in the company beyond the date that the corrective statements were made—some eight months after the class closing date.[94] However, this might be resolved more appropriately by viewing it as a problem with the class certification, rather than a blanket declaration on the means for pleading or proving loss causation. If the Court is correct in its assertion, those members of the class that had sold their shares before the subsequent correction may not have been hurt by the defendants' misrepresentations. On the other hand, the Eighth Circuit's holding that "[p]aying more for something than it is worth is damaging"[95] has a logical appeal of its own and may be more consistent with the PSLRA legislative history discussed above.[96] At the very least, the plaintiffs have lost the opportunity to use the value of the inflation for other pursuits.

The *Dura* Court, however, went further to aver that it is "far from inevitabl[e]" that the purchase price, artificially inflated by defendant's misstatements, will cause a loss to the plaintiff—even "after the truth makes its way into the market place."[97] Where the

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[90] *Id.* at 1631 (citing Broudo v. Dura Pharmaceuticals, Inc., 339 F.3d 933, 938 (9th Cir. 2003)).
[91] *Id.*
[92] *See Id.*
[93] *Id.*
[94] *Id.* at 1629-30.
[95] Gebhardt v. Conagra Foods, Inc., 335 F.3d 824, 831 (8th Cir. 2003).
[96] H.R. CONF. REP. NO. 104-369 at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.
[97] *Dura Pharm.*, 125 S. Ct. at 1631-32.

plaintiff resells his or her stock at a lower price after the misrepresentations have been corrected, it is possible that "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."[98] The likelihood that a price change is related to the defendant's misrepresentations deteriorates with the passage of time between plaintiff's purchase and sale of the stock.[99] "Given the tangle of factors affecting price, the most logic alone permits . . . is that the higher purchase price will *sometimes* play a role in bringing about a future loss," but "it is insufficient" to establish what the law requires.[100]

Evaluation of the Court's argument begins with an understanding that a plaintiff has failed to state a claim for which they are entitled to relief under 10b-5 if any of the five, aforementioned elements of a section 10(b) fraud action is absent.[101] Before a court is required to address the question of loss causation, all of the other elements of a 10b-5 action must first be met.[102] Assuming, as in *Dura*, a claim is based on falsely optimistic public misrepresentations, actionable misrepresentations must be material.[103] That is, the misrepresentations must be such that a reasonable investor would take them into consideration when deciding whether to purchase or sell the stock.[104] In *Basic*, the Supreme Court endorsed a fraud-on-the-market theory that "in an open and developed securities market, the price of a company's stock is determined by the available *material* information regarding the

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[98] *Id.* at 1632 (emphasis added).
[99] *Id.*
[100] *Id.*
[101] *See, e.g.*, In re Healthcare Compare Corp. Securities Litigation, 75 F.3d 276, 280 (7th Cir. 1996); Ganino v. Citizens Utilities Co., 228 F.3d 154, 161 (2d Cir. 2000); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1281 (11th Cir. 1999).
[102] Of course, the elements may be examined in any order the court chooses, but a significant interrelation between materiality, reliance, and loss may shape the order of examination. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 247 (1988); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965) ("the test of reliance is whether the misrepresentation is a substantial factor in determining the course of conduct which results in (the recipient's) loss.") (internal quotation marks omitted) (citations omitted); Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).
[103] 17 C.F.R. § 240.10b-5(b) (2005).
[104] *See Basic, Inc.*, 485 U.S. at 231-32.

company and its business."[105] "Because most publicly available information is reflected in [the] market price," the fraud-on-the-market theory creates a rebuttable presumption that an investor relied on the integrity of an inflated price, and, consequently, the defendant's material misrepresentations, when they purchased the stock.[106]

Therefore, if the defendant's misrepresentations were material, presumptively affecting a change in the market price upon which we can assume the plaintiff relied, a 10b-5 action then requires that the statements were made with a wrongful state of mind. That is, the defendant must have acted with intent or knowledge of the inaccuracy of the material misrepresentations: the defendant did not act in good faith.[107] Consequently, it is assured that a court won't assign liability to an innocent-hearted defendant who spouts material misrepresentations, regardless of how loss causation is resolved.[108] Finally, in a situation like *Dura*, the misrepresentation would have been "in connection with the purchase or sale of"[109] stock because the plaintiffs actually purchased shares.[110] It is in this context that we must determine whether the material misrepresentations caused the plaintiffs' losses.

Assuming, *arguendo*, a plaintiff resold her shares at the artificially inflated market price, representing the same material misrepresentations that existed at the time of purchase, the Court's reasoning has a certain appeal. It seems likely that the individual plaintiff in that case has not been harmed by the defendant's misrepresentation beyond paying more for Dura stock than it was worth. Then again, it is also possible that the plaintiff could be injured by material misrepresentations even where the truth never makes its way to the market, notwithstanding the Eighth Circuit and PSLRA history.[111] The question, however, must be whether the

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[105] *Id.* at 241 (quoting Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)) (emphasis added).
[106] *Id.* at 247, 248.
[107] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197, 199 (1976) (clarifying that scienter requires more than negligence).
[108] As the Court points out, securities regulations are not meant to act as broad insurance for investors. Dura Pharmaceuticals, Inc. v. Broudo, 125 S. Ct. 1627, 1633 (2005). They are intended to achieve a high level of business ethics in the market. Affiliated Ute Citizens v. United States, 406 U.S. 128, 150 (1972).
[109] 17 C.F.R. § 240.10b-5 (2005).
[110] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-32 (1975).
[111] For example, if Plaintiff paid one additional dollar per share for Company X as a result of material misrepresentations, but due to unrelated market circumstances the

plaintiff can prove a loss at this point by simply showing she paid more for the securities than they were worth. If paying more than something is worth is damaging, then she should be able to do so. The Court addresses this issue succinctly: "[an] artificially inflated purchase price is not itself a *relevant* economic loss."[112]

Conversely, where all of the abovementioned preconditions are met, it is difficult to understand how the misrepresentations could avoid injuring a plaintiff who did not resell his or her shares until after the market became aware of the true nature of the misrepresentations.[113] It has already been established, absent some special intervening circumstances, that the misrepresentations, if material, presumptively caused the price of the stock to rise artificially. Special circumstances might negate the price assumption where, for example, the "market makers were privy to the truth" and never incorporated the misstatements into the market price.[114] Such circumstances, however, must be truly rare in a large, well-developed market, so it's not the case in this hypothetical.

The Court in *Dura Pharmaceuticals* assumes that Dura's stock was overpriced at the time of purchase.[115] Therefore, after the market became aware of the truth of the matter, the value that had been attributed to misrepresentation must have gone somewhere. Perhaps the market would not have needed readjustment when the corrective statement was issued if the material idea embodied by the misrepresentations had already become valueless.[116] In that case the defendant's misrepresentations would simply injure the plaintiffs at that earlier date when the stock lost the artificially inflated value. It

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misrepresentations subsequently became valueless before being corrected, Plaintiff would certainly have lost a dollar per share as a result of paying an unnecessarily inflated price for the defendant's material misrepresentations. The unrelated market corrections could be considered an intervening variable in Plaintiff's loss, but it is Defendant's lies that augmented the price initially and proximately caused the loss. The market conditions merely changed the time at which the loss was realized upon Plaintiff. It does not make the form or extent of the loss unforeseeable or put the injury beyond "the range of apprehension" for the defendant's act. *See e.g.*, Palsgraf v. Long Island Railroad Co., 248 N.Y. 339, 344 (1928) (citation omitted).

[112] *Dura Pharm.*, 125 S. Ct. at 1634 (emphasis added) (internal quotation marks omitted).

[113] *But see Id.* at 1631-32.

[114] Basic, Inc. v. Levinson, 485 U.S. 224, 248 (1988) (internal quotation marks omitted).

[115] *Dura Pharm.*, 125 S. Ct. at 1631.

[116] For example, if a competitor had released a new asthma treatment that rendered the Albuterol Spiros system obsolete and worthless, the value embodied in the misrepresentation would have been lost.

follows that the date that corrective statements were issued would have been the latest point where the plaintiffs' losses could have occurred.

It seems quite illogical, indeed, to recognize that in a well-developed market, public information is incorporated into a company's stock price, yet accept that the false value could be exchanged for unrelated real value without hurting investors that gave consideration for that false value. Even if the exchange for real value was simultaneous so that investors never saw any decline in price, an investor that paid the inflated price would have been cheated out the price appreciation that would have occurred absent the misrepresentations. Furthermore, even if the price actually rose due to other market conditions coincident to the defendant's release of a corrective statement, the plaintiffs who paid the inflated purchase price would still lose out: proportionate gains would have been larger absent the defendant's material misrepresentations.[117] Accordingly, the Eighth Circuit recognized that "stockholders can be damaged in ways other than seeing their stocks decline."[118] "If a stock does not appreciate as it would have absent the fraudulent conduct, investors have suffered harm."[119]

Whether market conditions or corrective statements caused damage to the plaintiffs, therefore, depends on the value given to the misrepresentations in the first place. Moreover, a court should not "attach dispositive significance to the stock's price movements absent sufficient facts and expert testimony."[120] Again, the question presented is whether the plaintiffs could establish loss causation by simply proving that they paid an inflated price for Dura's stock. Assuming that paying an inflated price, with its associated opportunity costs, "is not itself a relevant economic loss," then any plaintiffs who paid an inflated purchase price and subsequently sold their shares before any market readjustment of share value resulting from the material misrepresentations would fail to show loss causation by establishing an inflated purchase price alone. [121]

If, however, the plaintiffs held their shares until after Dura issued a corrective disclosure, proving that they paid an inflated purchase price would, *ipso facto*, almost certainly prove that Dura

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[117] *C.f.* Gebhardt v. Conagra Foods, Inc., 335 F.3d 824, 831-32 (8th Cir. 2003).
[118] *Id.* at 831.
[119] *Id.* at 831-32.
[120] *Id.* at 832.
[121] *See Dura Pharm.*, 125 S. Ct. at 1634.

damaged the plaintiffs. Therefore, a presumption of loss causation in such a situation would be justified by "considerations of fairness, public policy, and probability, as well as judicial economy."[122] Even if the inflated stock value could somehow vanish without displacing gains that shareholders otherwise would have realized, the defendant's ability to rebut the presumption of loss would mitigate the dangers of false conviction and overprotection of stock owners with which the Court is concerned. This approach would also effectuate the purpose of federal securities regulations to encourage full, honest disclosure in the market.[123] Considering that a defendant must have acted with scienter if loss causation analysis is consequential, placing this burden on the defendant's unclean hands seems fair.

Paying an inflated purchase price, without more, could be sufficient to prove loss causation only where all class members actually held the stock at the time the market adjusted to Dura's corrective disclosure. Because paying an inflated purchase price is not a relevant economic loss according to the Supreme Court,[124] establishing that fact *alone* would be sufficient only if a corrective disclosure had been made: as previously discussed, we can safely presume the artificial value cannot be recovered through resale by that point at the latest. The plaintiffs could also establish that the artificial value was lost prior to the disclosures, but this would obviously require more than merely showing they paid an inflated purchase price.

The Ninth Circuit's analysis of loss causation is illogical in *Dura* precisely because the Supreme Court rejects the Eighth, and presumptively Ninth, Circuit recognition that "paying more for something than it is worth is damaging."[125] While this conclusion is debatable, the Court's decision is defensible and the line has been drawn. However, if the certified class were composed of purchasers of Dura Pharmaceuticals stock who retained their shares beyond Dura's corrective disclosures, it would be logical and efficient to presume, upon a showing that the plaintiffs paid an inflated purchase price, that Dura's misrepresentations proximately caused a loss to the plaintiffs. The Court's opinion is contrary to this contention.[126]

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[122] Basic, Inc. v. Levinson, 485 U.S. 224, 245 (1988).
[123] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972).
[124] *Dura Pharm.*, 125 S. Ct. at 1634.
[125] *Gebhardt*, 335 F.3d at 831; *See also* Broudo v. Dura Pharmaceuticals, Inc., 339 F.3d 933, 938 (9th Cir. 2003).
[126] *See Dura Pharm.*, 125 S. Ct. at 1631-32.

III. Potential Implications of the Court's Loss Causation Ruling

The Supreme Court's holding in *Dura Pharmaceuticals* has implications beyond the lower court's lenient approach to proving loss causation. The Court declared that "the Ninth Circuit's approach" to loss causation was "inconsistent with the law's requirement that a plaintiff prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss."[127] After the Court concluded its examination of the Ninth Circuit's analysis, as discussed above, the Court directly considered the plaintiffs' pleadings in the case at hand. Accordingly, the Court found that the Ninth Circuit erred in concluding that the plaintiffs' complaint satisfied even the simple notice pleading requirements of Rule 8(a)(2) of the Federal Rules of Civil Procedure.[128]

Although "ordinary pleading rules are not meant to impose a great burden upon a plaintiff," the Court rebuked the complaint for failing to give "notice of what the relevant economic loss might be or of what the causal connection might be between the loss and the misrepresentation concerning Dura's 'spray device.'"[129] This pleading requirement is necessary, the court continued, to prevent "abusive practices"[130] whereby plaintiffs could file "largely groundless" lawsuits permitting them to "take up the time of a number of other people," essentially extorting settlements disproportionate to the merits of the case.[131] The Court does not provide any indication or suggestion as to how the plaintiffs could have met their specific pleading burden.

The Court's seemingly simple statements may have a substantial impact on future plaintiffs pleading 10b-5 claims. Perhaps the Court has very simple clarifications in mind, such as requiring plaintiffs to allege that they not only paid an inflated purchase price, but that the value of the shares was negatively impacted by corrective statements or market adjustments that otherwise would not have happened. This presumably requires

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[127] *Id.* at 1633-34.
[128] *Id.* at 1634 (citing Conley v. Gibson, 355 U.S. 41, 47 (1957).
[129] *Id.* (citation omitted).
[130] *Id.* (citations omitted).
[131] *See id.* (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975)).

plaintiffs to specifically assert that the defendant's misstatements and subsequent corrections were responsible for both inflating the price and causing the ensuing drop. However, the PSLRA already requires plaintiffs to state all of the misrepresentations alleged as the basis for their claims and how they are misleading.[132] Consequently, these added disclosures would provide little additional notice or substance for defendants at little cost to plaintiffs. On the other hand, requiring plaintiffs to plead anything substantially more specific could prove to be a significant challenge. Determining the precise value of the economic loss associated with the defendant's misrepresentations would likely be a major issue at the trial level, and it would certainly require the assistance of an expert to draft the complaint. Furthermore, while a more substantial pleading requirement may inhibit meritless claims designed to extort the value of avoiding bothersome litigation from honest defendants, it will also impede meritorious claims from ever seeing the discovery phase of litigation.

Another potential consequence of the Court's opinion arises from its conclusion that an inflated purchase price might never proximately cause a loss to investors.[133] "Other things being equal, the longer the time between purchase and sale, the more likely this is so, *i.e.*, the more likely that other factors caused the loss."[134] Such a conclusion would tend to encourage potential defendants, rationally, to cover up their misrepresentations as long as possible. The implications of this policy are unclear for the liability of a defendant who could conceal the truth for an extended period of time. Presumably, a clever defendant could mitigate its responsibility for intentional, material misrepresentations by tying corrective statements to unrelated positive announcements or merely waiting for the material idea embodied by the misrepresentation to lose its market value. Rewarding defendants who cleverly conceal their misdeeds doesn't appear to encourage higher "standards of business ethics in the securities industry."[135]

Although the Court claims that the Ninth Circuit's loss causation analysis is unique among the circuits, as previously discussed, the *Dura* holding seems to be at odds with the Eighth Circuit's discussion of loss causation in *Gebhardt* as well.[136] How

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[132] 15 U.S.C. § 78u-4(b)(1) (2000).
[133] *Dura Pharm.*, 125 S. Ct. at 1632.
[134] *Id.*
[135] Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (internal quotation marks omitted) (citation omitted).
[136] *See* Gebhardt v. Conagra Foods, Inc., 335 F.3d 824, 831-32 (8th Cir. 2003).

this opinion will impact future decisions in either of those circuits remains to be seen. Also, while the court cites the Second, Third, Seventh and Eleventh Circuits as authorities contrary to the Ninth Circuit, the Court makes no qualitative statements regarding the handling of loss causation in those circuits.[137] Presumably, the Court approves of the cited lower courts' treatment of the issue, and they could prove to be a fruitful source of further guidance on how a plaintiff must plead as well as prove loss causation.

IV. Conclusion

In *Dura Pharmaceuticals v. Broudo*, the Supreme Court held that the Ninth Circuit erred in reversing the dismissal of a 10b-5 claim where the plaintiffs' only allegation of loss causation was that they "paid artificially inflated prices for Dura's securities and suffered damage[s]."[138] The Court concluded that the Ninth Circuit's loss causation analysis was unsupported by common law precedent, unique among the circuits, inconsistent with securities regulation objectives and illogical. Furthermore, the Court noted that an "artificially inflated purchase price is not itself a relevant economic loss."[139] Consequently, according to the court, the plaintiffs failed to state a claim against the defendants. The Supreme Court reversed the lower court's judgment and remanded the case for further, consistent proceedings.

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[137] *See Dura Pharm.*, 125 S. Ct. at 1630, 1632-33.
[138] *Id.* at 1634.
[139] *Id.*