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Ninth Circuit Affirms Dismissal Of Section 14(a) Class Action Holding That A Share Dilution Theory For Pleading Economic Loss Is Unsupported By Case Law

In *New York City Employees' Retirement System v. Jobs*, No. 08-16488, 2010 WL 309028 (9th Cir. Jan. 28, 2010), the United States Court of Appeals for the Ninth Circuit affirmed the dismissal of a class action lawsuit against Apple, Inc. ("Apple") and fourteen of its officers and directors for the alleged false and misleading proxy solicitation of a stock option plan on the ground that plaintiff-appellant did not adequately plead economic loss in the form of "dilution to shareholder interests." This decision provides yet another instance where courts have strictly applied the "loss causation" principles set forth in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342-48 (2005), in describing the contours of "loss" in private actions under the federal securities laws.

Plaintiff-appellant New York City Employees' Retirement System ("NYCERS") is a public pension fund that manages retirement assets for over 200,000 current and former employees of the City of New York. In its consolidated complaint, it alleged direct class claims under Sections 14(a) and 20(a) of the Securities Exchange Act of 1934. NYCERS claimed that Apple's 2005 proxy statement was materially misleading based on allegations that Apple "backdated" 6,428 stock options between 1997 and 2002. Apple, it was alleged, compensated some employees by awarding stock options that were dated on a date earlier than when the stock options were actually issued, usually at a date when the stock price was lower. This benefited the recipients of the options, which were "in the money" from the time of receipt.

NYCERS alleged that the backdating of stock options rendered Apple's 2005 proxy statement false and misleading for three reasons. First, NYCERS alleged that while the proxy statement explained that Apple's compensation practices "aligned the interests of employees and stockholders" because stock options would have value only if Apple's stock price increases, Apple's issuance of "backdated" options could have value even if Apple's stock price does not increase, thereby decoupling employee and shareholder interests. Second, the proxy statement reported that granted options did not make up for the below market cash compensation paid to executive officers. NYCERS alleged misrepresentation because backdating can surreptitiously increase compensation. Third, the proxy statement also indicated that in March 2003, Steve Jobs, Apple's Chairman and CEO, canceled his outstanding options in exchange for ten million (split adjusted) shares of restricted stock. NYCERS alleged that this was misleading because some of the canceled options were backdated, improperly providing Jobs with 630,000 extra shares valued at over $50 million.

According to NYCERS, Apple shareholders suffered injury by reason of the allegedly false and misleading 2005 proxy statement through impairment of their right to a fully informed vote and the substantial dilution of their shares. NYCERS asserted that from 1996 to 2005, shareholders "unwittingly" authorized issuance of a total of 205 million shares, or 20% of Apple's stock.

The United States District Court for the Northern District of California dismissed the Section 14(a) claim, holding (among other things) that the consolidated complaint failed to plead loss causation under the Private Securities Litigation Reform Act of 1995 ("Reform Act"). NYCERS appealed.

The Ninth Circuit held that to state a claim under Section 14(a) and Securities & Exchange Commission Rule 14a-9, private plaintiffs must plead that (1) a proxy statement contained a material misrepresentation or omission which (2) caused the plaintiff injury and (3) that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. In addition, private plaintiffs must meet the heightened pleading standards of the Reform Act, as well as its requirement to plead loss causation.

Relying upon *Grace v. Rosenstock*, 228 F.3d 40, 47 (2d Cir. 2000), the Ninth Circuit held that loss causation *must* be proven in the context of a private action under Section 14(a) and Rule 14a-9. As codified, loss causation requires a showing that the defendant "caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). NYCERS sought to plead economic loss in the form of "dilution to shareholder interests." In dismissing the claim, the district court held that "dilution is not necessarily accompanied by economic loss" and that the principles of *Dura Pharmaceuticals* bars any suit brought solely on the basis that a misrepresentation caused an inflated share price.

In *Dura Pharmaceuticals*, the Supreme Court considered whether investors successfully plead economic loss by alleging they paid artificially inflated prices for [the issuer's] securities. 544 U.S. at 347. The Supreme Court held that the complaint was "legally insufficient" because an "'artificially inflated purchase price' is not itself a relevant economic loss." *Id.*

NYCERS alleged economic loss only in the form of dilution of their shareholdings and, as such, purportedly did not seek to rely on *Dura Pharmaceuticals*. Instead, NYCERS argued that *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), grants courts broad authority to fashion *equitable remedies* for Section 14(a) claims. The Ninth Circuit, however, discounted NYCERS' argument, holding that the Reform Act does not differentiate between plaintiffs seeking legal and equitable remedies. Accordingly, pursuant to *Dura Pharmaceuticals*, without an allegation of economic loss no remedy, equitable or otherwise, is available.

NYCERS next argued that even if *Dura Pharmaceuticals* were to apply, it does not purport to establish a single method of proving loss causation. Nonetheless, the Ninth Circuit held that regardless of whether courts have recognized other showings of loss causation, *Dura Pharmaceuticals* still requires that the pleadings provide notice of what the relevant economic loss might be. Here, NYCERS stated that the dilution “reduce[d] a shareholder’s percentage of ownership” and that “this 20% transfer clearly ha[d] a highly significant economic consequence even though the Company’s share price may not have moved in response to the transfer.” The Court was not persuaded. In contrast, the Court held that NYCERS’ dilution theory of economic loss is unsupported by caselaw, and, as the district court recognized, economic loss does not necessarily accompany dilution. Thus, the court held that “such conclusory assertions of loss are insufficient” and the district court’s dismissal on that ground was proper.

The Ninth Circuit declined to expand the concept of “economic loss” required to state a Section 14(a) claim to include shareholder dilution. Instead, by applying *Dura Pharmaceuticals* and the Reform Act strictly, the Ninth Circuit limited the scope of potential Section 14(a) claims.

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