CORPORATE LAW AND PRACTICE
Course Handbook Series
Number B-2021

Handling a Securities Case 2013:

From Investigation to Trial and Everything in Between

Co-Chairs
Lyle Roberts
Jonathan K. Youngwood

To order this book, call (800) 260-4PLI or fax us at (800) 321-0093. Ask our Customer Service Department for PLI Order Number 43080 Dept. BAV5.

Practising Law Institute
810 Seventh Avenue
New York, New York 10019

10

RECENT DEVELOPMENTS IN LOSS CAUSATION

Jordan Eth
Su-Han Wang

Morrison & Foerster LLP

February 8, 2013

BIOGRAPHICAL INFORMATION

Su-Han Wang
Associate
Morrison & Foerster LLP

Su-Han Wang is an associate in Morrison & Foerster's Litigation Department.

Ms. Wang earned her J.D. from Columbia Law School, where she was a Harlan Fiske Stone Scholar, staff editor of the Columbia Journal of Asian Law, and an executive board member of the Society for Law, Science and Technology. She earned her B.A., with high honors, from the University of California, Berkeley.

Ever since the Supreme Court's ruling in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), loss causation has become one of the most commonly litigated issues in securities litigation, arising in nearly every phase of a case, from pleadings, to class certification,[1] summary judgment, trial, and post-trial. The prominence of loss causation makes sense, as securities laws seek to compensate investors only for losses caused by fraud,[2] and not by the many other factors that affect stock fluctuations.

Despite the recent volume of litigation involving loss causation, results are inconsistent at best. There are numerous open issues, ranging from the appropriate pleading standard to the degree of connection between the corrective disclosures and the alleged fraud. Recent appellate cases highlight some of these issues and demonstrate the lack of predictability in loss-causation jurisprudence.

I. LOSS CAUSATION WHEN MULTIPLE FACTORS AFFECT A STOCK'S DECLINE

One recurring issue that has divided courts and often proven dispositive is the extent of plaintiffs' burden to demonstrate that factors other than the fraud did not cause plaintiffs' losses.

In *Gould v. Winstar Communications, Inc.*, 692 F.3d 148 (2d Cir. 2012), the Second Circuit vacated summary judgment for defendant Grant Thornton LLP (GT), Winstar's independent auditor. The district court had granted summary judgment on scienter and reliance grounds.[3] In reversing on appeal, the court also addressed loss causation, an alternative ground for affirmance offered by defendants.

The facts were straightforward: On February 10, 2000, GT issued an unqualified audit opinion stating that Winstar's Form 10–K for fiscal year 1999 complied with GAAP and fairly represented Winstar's financial condition. The plaintiffs submitted evidence that, at that time, GT

1. The Supreme Court's ruling in *Erica P. John Fund v. Halliburton Co.*, 131 S.Ct. 2179 (2011) will greatly narrow the relevance of loss causation at the class certification stage.
2. Section 11 claims seek to compensate investors for losses caused by "material misrepresentations." In those cases, defendants bear the burden of demonstrating "negative causation" to remove from damages fluctuations in stock price unrelated to the alleged misrepresentation. *See, e.g.*, *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 574 F.3d 29, 32-33 (2d Cir. 2009).
3. *Gould* involved a claim under Section 18, so plaintiffs were required to prove actual reliance.

had not adequately resolved its concerns about Winstar's revenue recognition for several large transactions.

The plaintiffs alleged that press releases in March and April 2001 by an investment firm and Winstar itself "suggested for the first time that Winstar had engaged in improper revenue recognition practices" during the period covered by GT's audit opinion.

Defendants offered multiple reasons besides the alleged fraud for the stock price decline, including broader market trends, a downgrade in Winstar's credit rating, and the cancellation of the company's credit facility. The court, however, ruled that these factors could "hardly foreclose the reasonable inference that some part of the decline was substantially caused by the disclosures about the fraud itself."[4] For that reason, the court found that a jury could reasonably find a causal link between the alleged misconduct and the economic harm.

The court in *Phillips v. Scientific-Atlanta, Inc.*, 489 F. App'x 339 (11th Cir. 2012), by contrast, affirmed summary judgment on loss causation grounds, and placed a heavy burden on plaintiffs to eliminate alternative explanations for a stock price decline. Plaintiffs alleged that defendants had issued a series of public statements describing "rising customer demand" for its products. In fact, according to plaintiffs, the defendant company's increased sales resulted from "channel stuffing" based on "discounts, warehousing credits, unusually liberal return policies" and similar incentives. Months later, the company announced a slowdown in sales, pointing to numerous factors, such as the economic climate, industry developments, and customers holding large inventories.

The court stated that to prove loss causation, plaintiffs must eliminate other possible explanations for a drop in stock price.[5] This allows the fact finder to infer "that it is more probable than not that it was the corrective disclosure—as opposed to other possible depressive factors—that caused at least a 'substantial' amount of the price drop."

Through their expert, plaintiffs presented evidence that "disaggregated" the "effects of some of the confounding factors."[6] The expert "sufficiently accounted" for industry-wide factors, for example, removing them from the damage calculations. The expert, however, did

---

4. *Gould v. Winstar Commc'ns, Inc.*, 692 F.3d 148, 162 (2d Cir. 2012).
5. *Phillips v. Scientific-Atlanta, Inc.*, 489 F. App'x 339, at *3 (11th Cir. 2012).
6. *Id.* at *4.

not account for "the impact of Defendants' statements that accurately presented the industry-wide factors" and how they specifically affected the company.[7]

Under *Winstar*, this may have been enough, as plaintiffs appeared to link at least some of the decline to the alleged fraud. The Eleventh Circuit, however, applied a different, more stringent test. It found that plaintiffs must "eliminate other possible explanations for this price drop."[8] Otherwise, the fact finder cannot infer that it is "more probable than not" that the "corrective disclosure"— as opposed to other factors—"caused at least a substantial amount of the price drop."[9]

Hubbard v. BankAtlantic Bancorp, Inc., 688 F.3d 713 (11th Cir. 2012), is another loss causation case involving "confounding factors" that holds plaintiffs to a strict standard. In *Hubbard*, the plaintiffs alleged that the defendant bank holding company fraudulently misrepresented the risks associated with its subsidiary's commercial real estate portfolio. At trial, a jury found for the plaintiffs on some of their claims. The district court granted a motion for judgment as a matter of law (JMOL) for the defendants based on an inconsistency in the jury's responses to written interrogatories.

The Eleventh Circuit rejected the district court's reasoning, but affirmed judgment for the defendants on alternative grounds, namely that plaintiffs had failed to provide sufficient evidence of loss causation. In describing the law, the court discussed the distinctions between causation and damages, as well as two methods of proving loss causation.

Under one method, plaintiffs can prevail by demonstrating that the decline in a security's price is caused by "the market's reaction to a corrective disclosure revealing precisely the facts concealed by the fraud, as they existed at the time of the defendant's misstatements."[10] Another method—the validity of which the court assumed without deciding[11]—permits plaintiffs to prove loss causation by showing that the "materialization of a fraudulently concealed risk caused the price inflation induced by the concealment of that risk to dissipate."[12] The court found that plaintiffs could proceed only under this second

7. *Id.*
8. *Id.* at *3.
9. *Id.*
10. *Hubbard v. BankAtlantic Bancorp, Inc.*, 688 F.3d 713, 726 (11th Cir. 2012).
11. *Id.* at 726, n.25.
12. *Id*. at 726.

method—materialization of an undisclosed risk—as they did not (and could not logically) point to disclosures that corrected alleged misstatements with facts in existence at the time the alleged misstatements were made.

At trial, plaintiffs presented expert testimony based on an event study. The expert reviewed the decline in BankAtlantic's stock price on two dates. For each date, the expert removed both industry and market factors from the decline, using the NASDAQ Bank Index and the S&P 500 index.

The court ruled that this was inadequate. Plainly, much of the decline in Bancorp's stock price resulted from the "general downturn in the Florida real estate market—the risk of which Bancorp is not alleged to have concealed."[13] Where there are "confounding factors that could account for much of the decline in the price of the security, the plaintiff must offer some evidence separating the various causes of the decline in the security's price, <u>even to establish loss causation</u>."[14] Here, the NASDAQ Bank Index captured national trends only, and the expert admitted that Florida banks made up a small percentage of the index. Thus, the nationwide index was inappropriate for filtering out factors affecting BankAtlantic.

Because the alleged fraud must be a substantial factor in causing harm, plaintiffs must provide evidence that permits the jury to separate portions of the price decline attributable to non-fraud causes.[15] The Eleventh Circuit found that the plaintiffs failed to present evidence to exclude the possibility that the losses resulted from market forces that Bancorp "had warned of." Judgment as a matter of law for the defendant was proper.

II. LOSS CAUSATION WHEN THE ALLEGED MISSTATEMENTS DO NOT INCREASE THE AMOUNT OF "INFLATION" IN THE STOCK PRICE

Generally, loss causation is premised on the idea that a misrepresentation or omission causes the stock to rise and trade at an inflated price. Corrective disclosures injure shareholders because revelation of the truth

13. *Id.* at 729.
14. *Id.* at 726 (emphasis added). The court noted that to prove damages, plaintiffs must determine the amount of loss "solely caused by defendant's fraud."
15. *Id.*

results in dissipation of the inflation in the stock price. What about statements that cause no artificial inflation, but rather just perpetuate preexisting inflation? In *FindWhat Investor Group v. FindWhat.com*, 658 F.3d 1282 (11th Cir. 2011), the Eleventh Circuit ruled that these statements satisfy the requirement of loss causation.

The defendant company in *FindWhat* provided pay-per-click advertising. The district court granted summary judgment because the plaintiffs' expert testified that the stock price had been inflated before the class period even began, and that class-period misrepresentations did not change the amount of inflation. After the defendant allegedly revealed the falsity of its earlier statements, the inflation dissipated, and the stock price fell. The district court held that since the inflation was "caused" by statements made before the class period, the plaintiffs could not establish loss causation for statements made during the class period.[16]

The Eleventh Circuit disagreed. Citing district court cases and stating that "defendants who prop up an already inflated stock price do not get an automatic free pass under the securities laws," it held that information that prolongs a period of inflation, even without increasing the level of inflation, may be actionable.[17] According to the court, inflation causes an ongoing risk of harm. If investors who purchased stock at inflated prices still hold the shares when the truth comes out, they are unable to recoup the inflationary component of the stock price. Fraud that prevents preexisting inflation from dissipating is just as harmful as fraud that introduces inflation in the first place.[18]

There are some caveats. First, the court held in essence that defendants, and the district court, had approached this issue from the wrong point of view. Loss causation, according to the court, involves "back end causation"; that is, the connection between the decline in the stock price and the alleged previous misrepresentations.[19] Whether an alleged misstatement "causes" inflation in the first place is not a matter of causation at all, but rather is a question of reliance. Thus, the issue of whether plaintiffs may proceed with claims about "prolonging inflation" may be revisited as an issue of reliance. The Court also cited the contrary

16. *FindWhat Investor Group v. FindWhat.com*, 658 F.3d 1282, 1314 (11th Cir. 2011).
17. *Id.* at 1314-16.
18. *Id.* at 1317.
19. *Id.* at 1311.

views of the Fifth Circuit, which has found that statements prolonging inflation do not allege loss causation.[20]

III. LOSS CAUSATION ON THE PLEADINGS

Defendants regularly challenge loss causation at the pleadings stage. In *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039 (9th Cir. 2011), the Ninth Circuit addressed some of the issues that arise in this context, though in a case involving a private company defendant.

In *WPP*, the plaintiff alleged that defendants solicited large investments from WPP while Spot Runner founders were selling personal shares, but stating otherwise. The district court granted the motion to dismiss, finding that WPP inadequately pled loss causation. The Ninth Circuit reversed.

According to the plaintiff, the defendants "finally admitted" in March 2009 that the founders had been selling shares even though the company was in poor financial condition and needed capital.[21] In addition, the defendants allegedly revealed that the company had approximately $70 million in losses and less than $15 million in revenue in 2007 and 2008.

The Ninth Circuit noted that it was unclear whether "Rule 9(b)'s heightened pleading standard or whether Rule 8(a)(2)'s 'short and plain' statement applies to allegations of loss causation."[22] The court found it unnecessary to resolve this issue, as the complaint provided sufficient detail to give the defendants notice of the loss causation theory.[23]

The court noted that most securities litigation cases involve publicly traded companies. In those cases, plaintiffs must allege that the "share price fell significantly after the truth became known."[24] Where the defendant is a private company, as here, market prices are less relevant. For that reason, plaintiffs more commonly demonstrate loss causation by showing that the "revelation of the truth is directly related to the

---

20. *Id.* at 1314, n.33.
21. *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1046 (9th Cir. 2011) *cert. denied*, 132 S.Ct. 2713 (2012).
22. *Id.* at 1053.
23. *Id.* at 1053-54 (citations omitted).
24. *Id.* at 1053.

economic loss alleged"—similar to the standard for public companies, minus the requirements regarding share price reaction.[25]

Here, the court found it plausible that no investor would be willing to purchase shares held by WPP after the defendants' "pump and dump" scheme became public knowledge.[26] It did not matter that WPP did not plead "detailed share prices, the number of shares currently held, or whether attempts to sell the . . . shares were made." The allegations were sufficient to provide "some assurance that the theory has a basis in fact."[27]

IV. CONCLUSION

Loss causation plays an increasingly important role in almost every phase of securities litigation. Despite its fundamental importance, many outstanding questions remain. Courts are undecided about what pleading standard applies. Courts do not consistently weigh the effect of confounding factors or evaluate how well the plaintiffs disaggregated other causes from the alleged fraud. Courts also disagree whether statements that do not cause additional inflation nevertheless plead loss causation. Thus, despite loss causation's importance, the jurisprudence remains unpredictable.

25. *Id.*
26. *Id.* at 1054.
27. *Id.*

NOTES