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Loss Causation Challenges In Securities Cases

Law360, New York (October 21, 2009) -- The bursting of the U.S. housing bubble and the collapse of the related lending, securitization and investment markets in 2007 and 2008 devastated the financial performance and share prices of virtually all financial institutions.

In the wake of the crisis, the FDIC has shuttered over 100 banks; venerable Wall Street institutions Lehman Brothers, Merrill Lynch and Bear Stearns have toppled; and banking colossi CitiGroup and Bank of America have seen their stock prices drop to single digits.

Predictably following these sharp market price declines were a swarm of over two hundred investor class actions alleging that false and misleading disclosures, rather than the housing seismic wave, were the true causes of financial institution investor losses.

However, five 2009 appellate securities decisions focusing on loss causation foretell the difficulties plaintiffs bringing 10b-5 cases will face proving that fraud, instead of market forces or other negative but non-fraud factors, was the principal cause of their losses, especially given the industrywide declines in share values for financial institutions.

The first of the 2009 appellate decisions was In re Williams Securities Litigation — WCG Subclass, 558 F.3d 1130 (10th Cir., Feb. 18, 2009).

Following the Williams Communications Group's (WCG) bankruptcy in 2002, plaintiffs filed a 10b-5 class action alleging that WCG and its officers misrepresented the adequacy of WCG's capitalization, the reasons for WCG's spin-off a year earlier, and the ability of WCG to survive as a standalone company. The district court granted defendants summary judgment on loss causation.

On appeal, the Tenth Circuit focused its review on whether plaintiffs' expert's methods were reliable under Daubert v. Merrell Dow Pharmaceuticals and showed that plaintiffs'

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losses were caused by the alleged misrepresentations as required by Dura Pharmaceuticals Inc. v. Broudo.

In analyzing plaintiffs' proffered corrective disclosures, the Tenth Circuit recognized that while a corrective disclosure "need not precisely mirror the earlier misrepresentation ... it must at least relate back to the misrepresentation and not to some other negative information about the company." Williams, 558 F.3d at 1140.

Or, as the Second Circuit articulated this requirement in Lentell v. Merrill Lynch & Co. Inc., 396 F.3d 161 (2d Cir. 2005), "the risk that caused the loss [must be] within the zone of risk concealed by the misrepresentations and omissions." Id. at 173.

Two of the alleged corrective disclosures concerned announcements by WCG relating to filing for bankruptcy. The court found, however, that the causal connection between the bankruptcy filing and the false statements concerning the risk of WCG defaulting on its debt and the true reasons for its spin-off were "too remote to constitute a corrective disclosure" and that there were too many other intervening factors at play. Williams, 558 F.3d at 1142-43.

The other two alleged corrective disclosures concerned WCG's potential default on its debt obligations. While the court found that these disclosures could constitute corrective disclosures, the court noted that these announcements coincided with disclosure of other negative information not related to the alleged fraud.

The court affirmed that the expert's failure to consider the nonfraud factors that may have impacted WCG's price rendered his methodologies unreliable under Daubert.

The Williams opinion was followed by Lormand v. US Unwired Inc., 565 F.3d 228 (5th Cir., April 9, 2009). Plaintiff alleged that defendants concealed significant risks to its business posed by changes in the company's affiliate relationship with Sprint and misled investors by touting US Unwired's efforts to target subprime subscribers while allegedly knowing that such efforts would have disastrous consequences for the company.

In assessing whether the "truth" that plaintiffs alleged had emerged through a series of partial disclosures was "relevant" to the claimed fraud as required by Dura, the Fifth Circuit borrowed from the definition of "relevance" found in the Rule 401 of the Federal Rules of Evidence, holding that "the truth disclosed must simply make the existence of the actionable fraud more probable than it would be without that alleged fact (taken as true)." Lormand, 565 F.2d at 256 n.20.

Under this standard, the court held that plaintiff's complaint adequately alleged loss causation as to claims regarding US Unwired's efforts to target subprime credit class cellular subscribers, but not as to the claims regarding the alteration of the company's affiliate relationship with Sprint.

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Critically, each of the alleged partial disclosures identified in the complaint related to the claimed fraud regarding subscriber growth and the sub-prime credit marketing strategy.

Plaintiff, however, failed to plausibly suggest that a significant part of the alleged decline in US Unwired's stock price was caused by any revelation of truth concerning the change in the affiliate relationship.

The Fifth Circuit brought a different perspective to the developing jurisprudence on the required nexus between an alleged fraud and a corrective disclosure in Alaska Electrical Pension Fund v. Flowserve Corporation, 572 F.3d 221 (5th Cir., June 19, 2009), a per curiam opinion participated in by retired Associate Justice Sandra Day O'Connor.

The Flowserve plaintiffs alleged that Flowserve committed fraud when it issued inflated FY 2002 earnings guidance that did not reveal Flowserve's failure to comply with debt covenants, misstated historical financial performance, and made false statements concerning acquisition synergies.

In analyzing the issue of loss causation on plaintiffs' motion for class certification, the district court held that plaintiffs had failed to prove loss causation.

On appeal, the Fifth Circuit held that while a corrective disclosure need not be a "fact-for-fact" disclosure of information that fully corrects prior misstatements, it must be more than a mere disclosure of a company's weakened financial condition; instead, the court opined that the "true standard lies in the middle." Flowserve, 572 F.3d at 230.

More specifically, the disclosure "must reflect part of the 'relevant truth' — the truth obscured by the fraudulent statements." Id.

Applying this standard, the court held that the statements reducing earnings-per-share guidance need not directly reveal that the relevant earnings-per-share guidance was fraudulent; it is sufficient that the market learned that the guidance was wrong and that other unrelated negative information did not cause the decline in Flowserve's share price. Id. at 231.

The court emphasized, however, that a corrective disclosure must at least reflect part of the "relevant truth" obscured by the fraudulent statements, and that "loss caused solely by a general impression in the market that 'something is wrong' is insufficient to establish loss causation." Id. at 232.

In In re Flag Telecom Holdings Ltd. Securities Litigation, 574 F.3d 29 (2d Cir., July 22, 2009), the Second Circuit addressed corrective disclosure issues in the context of a Rule 23(f) appeal of a grant of class certification. Plaintiffs alleged that defendants made false statements regarding the strength of demand for Flag's fiber optic capacity.

In February 2002, the company disclosed that a significant portion of the company's revenues came from "reciprocal transactions" with other fiber optic carriers —

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characterized by plaintiffs as sham transactions designed to inflate revenues. Following this announcement, Flag's share price dropped 46 percent.

On appeal, defendants raised several challenges to the class certification order, including an argument that the inability to prove loss causation subjected the class representative to unique defenses such that the representative could not satisfy the typicality and adequacy requirements of Rule 23(a).

In reversing part of the certification order, the Second Circuit observed that plaintiffs failed to link any of the information plaintiffs alleged had been "leaked" to the market to the reciprocal sale transactions at the heart of the alleged fraud. See Flag Telecom, 574 F.3d at 41.

Because plaintiffs failed to connect the price decline to a corrective disclosure, plaintiffs had not supplied sufficient evidence to establish that the class representative could prove loss causation. Id.

In Fener v. Operating Engineers Construction Industry and Miscellaneous Pension Fund (LOCAL 66), 579 F.3d 401 (5th Cir., August 14, 2009), plaintiffs claimed that the defendant media company had engaged in a fraudulent scheme to inflate circulation figures for a newspaper subsidiary.

The company had issued a press release reporting that an internal investigation discovered practices that had caused circulation figures to be overstated. The statement also referenced normal circulation declines that had been announced previously and forecasted further future declines. The next day, the stock dropped 7 percent.

In moving for class certification, plaintiffs did not submit an expert report on loss causation.

Defendants' expert argued that the disclosure at issue was comprised of three pieces of information, only one of which related to the alleged fraud: (1) declining circulation due to practices that resulted in overstatements; (2) previously reported circulation declines; and (3) anticipated future declines in circulation.

The defense expert also opined that the stock price decline was "primarily related" to the nonfraudulent disclosures.

In reply, plaintiffs submitted an expert report, but the district court rejected the expert's and plaintiffs' arguments that only the fraudulent disclosure affected the company's share price.

On appeal, the Fifth Circuit emphasized the critical importance of disaggregating the effects of nonfraudulent disclosures from that of fraudulent disclosures.

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Citing its previous decision in Oscar Private Equity Investments v. Allegiance Telecom Inc., 487 F.3d 261 (5th Cir. 2007), the court reiterated that the plaintiff must show that "it is more probable than not that it was this negative [corrective] statement, and not other unrelated negative statements, that caused a significant amount of the decline." Fener, 579 F.3d at 409 (quoting Oscar, 487 F.3d at 266).

The court then rejected plaintiffs' event study because it showed only how the stock reacted to the "entire bundle" of bad news in the release rather than just to the "culpable disclosure." Fener, 579 F.3d at 410.

Impact of 2009 Loss Causation Appellate Decisions on Financial Institutions Cases

The flurry of 2009 appellate rulings addressing loss causation illustrates the enormous challenges plaintiffs face establishing loss causation in suits involving precipitous industrywide declines, as did the telecommunications sector in the first part of this decade and the financial institutions segment in 2007 and 2008.

These cases make clear that plaintiffs must show a distinct nexus between the alleged fraud and the disclosure triggering the stock price drop, and that the negative corrective information, not negative information unrelated to the alleged fraud, was the cause of a significant amount of the stock price decline.

Considering the myriad of factors that have depressed financial institution share prices during the current financial crisis, plaintiffs will undoubtedly struggle to show that an alleged corrective disclosure was actually related to the alleged fraud and was a significant cause of the price decline.

Future decisions will provide additional guidance on the key unsettled question of strength of the connection required between information contained in the corrective disclosure and the alleged fraud.

There are currently three securities cases — In re Oracle Corporation Securities Litigation, In re Retek Inc. Securities Litigation and Archdiocese of Milwaukee v. Halliburton Co. — on appeal in the Ninth, Eighth and Fifth Circuits respectively, in which the district courts found that the plaintiffs had failed to establish loss causation.

No matter how these decisions unfold, loss causation is certain to be a formidable shield against liability and, thus, among the most heavily litigated issues in financial crisis related securities class actions.

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