Loss Causation in Light of *Dura*—Recent Cases

BY WARREN R. STERN

Warren R. Stern is a partner in the litigation department at Wachtell, Lipton, Rosen & Katz. Mr. Stern is also a member of the Editorial Board of Securities Litigation Report. Contact: WRStern@WLRK.com.

This article reports on two recent district court cases exploring loss causation issues in light of *Dura Pharmaceuticals, Inc. v. Broudo*.[1] The cases are *Ryan v. Flowserve Corp*.[2] and *In re Omnicom Group, Inc. Securities Litigation*.[3] Both decisions illustrate how lower courts are analyzing the required connection between the fraud and the economic loss, and should help both plaintiff and defense counsel prepare for what is becoming an increasingly contested issue in securities litigation.

In *Dura Pharmaceuticals*, the plaintiff, on behalf of a class of purchasers of Dura stock between April 15, 1997, and February 24, 1998, sued Dura under Section 10(b) of the Securities Exchange Act and Rule 10b-5, claiming that, during the class period, Dura made false statements concerning the prospects for Food and Drug Administration (FDA) approval of a new device and thereby artificially inflated the price of its stock. On February 24, 1998, Dura announced that its earnings would be lower than expected because of slow drug sales; on the next day, the price of Dura's shares declined by almost 50%. Eight months later, Dura announced the FDA would not approve the device; on the next day, the price of Dura's shares fell but recovered within a week.

The district court dismissed the complaint, holding that the complaint failed adequately to allege "loss causation." The Court of Appeals for the Ninth Circuit reversed, holding that the injury occurred when the plaintiffs purchase shares at prices inflated by the alleged misrepresentation.

The Supreme Court disagreed, holding that "an inflated purchase price will not itself constitute or proximately cause the relevant economic loss."[4] A securities fraud plaintiff, the Court held, must show that the "share price fell significantly after the truth became known" and that the lower price must reflect the "earlier misrepresentation," *not* "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."

Prior to *Dura Pharmaceuticals*, a number of circuits had held that purchase price inflation did not constitute economic loss for purposes of securities fraud actions. But the Supreme Court's emphasis on the causal relationship between stock price change and an alleged misrepresentation is leading to rigorous scrutiny of loss causation claims and, by extension, to claims of materiality and reliance. Most notably, in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,[5] the Court of Appeals for the Fifth Circuit held that plaintiffs who failed to show that an alleged misrepresentation caused their economic loss could not rely on a presumption of reliance on that misrepresentation for purposes of class certification.

Loss-causation analysis greatly complicates the prosecution of securities fraud actions. Seldom do the facts show a clear of sequence of a misrepresentation, followed by a correction, followed by the stock drop giving rise to the lawsuit. More commonly, the stock drop follows disclosure of a number of confounding events, some industry- or market-related, others perhaps company-specific but apparently unrelated to the alleged misrepresentation. In those cases, plaintiffs resort to expert testimony to establish the causal link. But, as in *Allegiance Telecom*, such testimony often leads to "little more than well-informed speculation."[6] *Flowserve* and *Omnicom* illustrate the point.

In *Flowserve*, the plaintiffs, on behalf of a class of purchasers of Flowserve stock between February 6, 2001, and September 27, 2002, sued Flowserve and others for violations of Section 10(b) and Rule 10b-5, and for violations of Section 11 of the Securities Act of 1933. Plaintiffs claimed that, during the class period, Flowserve made false statements concerning integration of acquired businesses, falsely reported financial results, violated debt covenants, and falsely predicted increases in earnings. Plaintiffs claimed that the fraud was revealed by two press releases—one, issued on July 22, 2002, the other on September 27, 2002. Both releases reported declining sales and lowered earnings expectations and both were quickly followed by declines in Flowserve's stock price.

The district court denied the plaintiffs' motion for class certification on the ground that the plaintiffs had failed show that the alleged misrepresentations caused their loss, and granted the defendants' motions for summary judgment on the Section 11 claims on the ground that the claims could not survive defendants' affirmative defense showing that a lack of a causal connection between the alleged misstatements and plaintiffs' losses. In so doing, the court lamented "the four years of litigation, which included 90 expert and fact depositions, document production topping 13 million pages, and the issuance of over 54 third-party subpoenas."[7] "Herein," the court remarked, "lies the *in terrorem* power of the class action and the extraordinary leverage Plaintiffs wield in this type of litigation. . . ."[8]

The rock on which the plaintiffs' case foundered was the simple fact (which, one suspects, should have been evident at the pleadings stage) that the plaintiffs' economic losses were not caused by disclosures that revealed any of the claimed misrepresentations. The business integration problems were disclosed in April and July 2001; the financial results were corrected by restatement in 2004; the possible breach of debt covenants was not disclosed in the July and September 2002 press releases; and those releases said nothing about false predictions of earnings increases.

The plaintiffs attempted to overcome these timing embarrassments by relying on testimony of Bjorn Steinholt, a well-known financial expert who frequently testifies for plaintiffs in securities fraud cases. The court found Steinholt's opinions "to be flawed and underwhelming in several aspects":[9]

1. the "central assumption that the alleged fraud and the July and September 2002 press releases are, in fact, related";[10]

2. the use of the "true financial condition" theory, which posits that "[w]here a company discloses reduced operating performance, financial condition and prospects as a result of

problems that previously had been concealed by some fraudulent conduct, then the resulting price decline is directly tied to the fraudulent conduct, even if the fraudulent conduct itself is not revealed," a theory that the court called "dangerous," "speculation," and "an insurance policy for investors";[11] and

3. treatment of "forward-looking" analyst concerns about covenant violations as evidence that the July and September releases disclosed actual covenant violations.[12]

The court also found that plaintiffs' proffer of thousands of pages of internal Flowserve documents obtained in discovery to be "immaterial" because the market "never learned directly or indirectly" of the problems evidenced by those documents.[13] For all of these reasons, the court found that the plaintiffs had failed to carry their burden under *Allegiance Telecom* of proving, at the class certification state, a causal relationship between their claimed losses and the alleged misrepresentations.

But the court didn't stop there. The opinion assumed "*arguendo* the unlikely scenario that some related truth did leak out," but nevertheless found "that the claimed falsehoods did not and could not have played a significant role in causing the July and September 2002 price declines."[14] The court based this finding on the defendants' "event studies and review of analyst commentary," which showed that Flowshare's disclosed financial results and reduced earnings estimates "more likely than not played the substantial roles in precipitating the . . . stock price declines."[15] Defendants showed:

1. those factors were cited in "contemporaneous market commentary";[16]

2. peer companies, "not accused of engaging in any fraud," suffered price declines at the same time and for the same reasons as Flowserve;[17] and

3. there was no statistically significant price declines when the restatements and related matters were announced in 2004.[18]

The court summed up with a strong warning against loss causation arguments of the type proffered by Steinholt:[19]

> **Under his approach . . . *any* revised earnings shortfall, regardless of the stated cause, would necessarily be caused by any subsequent discovery of an undisclosed fraud. In practical terms, if any corporate defendant ever files a restatement, it will virtually guarantee investors the ability to recoup for any loss. Any plaintiff can review the company's performance, selectively pick the steepest stock price fall, certify a class, and collect a windfall on the ad-hoc insurance policy. This approach dooms any chance for class certification of Plaintiffs' claims under the Securities Exchange Act.**

Turning to defendants' motion for summary judgment on the Section 11 claims, the court found that the defendants' expert witnesses showed, without material contradiction by plaintiffs, that the July and September releases did not cause the market to question Flowshare's historical financial statements, internal controls, compliance with debt covenants, or other matters disclosed in the registration statements on which plaintiffs based their claims.[20] Again, the court emphasized that "a failure to meet earnings forecasts has a *negative* effect on stock prices, but not a *corrective* effect."[21]

Flowshare involved non-corrective news that caused a sharp stock drop, followed by corrective news that caused no stock drop. *Omnicom* involved corrective news that caused no stock drop, followed by non-corrective news that caused a sharp-stock drop. The plaintiffs claimed that Omnicom violated Section 10(b) and Rule 10b-5 by failing to write down poorly performing investments transferred to a private holding company. The transfer was described in several media reports between May and September 2001, and disclosed in Omnicom's Form 10-K on March 26, 2002. None of these disclosures was followed by a statistically significant price decline. On June 5, 2002, Omnicom filed a Form 8-K reporting the resignation of an outside director, and on June 11 and 13, 2002, news media said the director resigned after the Omnicom CEO informed the board that he wanted to buy back the investments, raising questions in the director's mind about the purpose of the original transaction. These reports were followed by significant declines in the price of Omnicom stock.

The plaintiffs alleged that the June reports disclosed negative commentary on Omnicom's accounting, that Omnicom intended to buy back the investments, and that the director resigned because he was concerned about the purpose of the original transaction and that it had not been adequately disclosed to the board. The court granted the defendants' motion for summary judgment, holding that the plaintiff had failed to raise a genuine issue of material fact on the issue of loss causation. The court held:

1. characterizations of previously disclosed facts are not corrective disclosures and, if "markets react negatively to a characterization, the 'loss is caused by the subsequent characterization of the transaction, not by the transaction itself'";[22]

2. the fact that Omnicom decided to buy back the investments did not suggest that the original transaction was a sham;[23]

3. the reports of the director's resignation did not constitute a corrective disclosure because they merely attributed an improper purpose to a previously disclosed transaction.[24]

Like *Flowshare, Omnicom* assumed for purposes of discussion that the news constituted a corrective disclosure and then examined the record to determine whether there was evidence that "the market reacted negatively to the disclosures, rather than to other information simultaneously released to the market."[25] The court examined an event study prepared by plaintiffs' expert, Scott D. Hakala, who, like Steinholt, frequently testifies for plaintiffs in securities fraud cases. The court found that Hakala's study failed to demonstrate loss causation because, to the extent that it identified any corrective disclosures, it did "not isolate their effect on Omnicom's stock price from that of the negative reporting, which dwarfed any shreds of new information disclosed in June 2002."[26] The court was particularly critical of Hakala's failure "to acknowledge any potential effect from [the news media's] highly negative tone" and to "analyze the effect of post-Enron 'changed investor expectations' on Omnicom's stock price.'"[27] Because the plaintiffs had failed to disaggregate the "confounding factors," the court found "no way for a juror to determine whether the alleged fraud caused any portion of Plaintiffs' loss."[28]

Conclusion

Flowshare and *Omnicom* point up the difficulties confronting securities fraud plaintiffs under a *Dura* analysis. They must identify a statement that corrects a prior statement and doesn't merely characterize or comment negatively on facts already disclosed or suggest the existence of undisclosed problems. If they can overcome that burden, they must then demonstrate that the market reacted to that correction, and not other factors or negative characterizations of disclosed facts. These questions turn on the content of the defendants' public statements and expert analysis of publicly available price data. Given the cost of litigation, there is every reason to resolve them prior to exposing courts, litigants, and witnesses to the costs of discovery.

NOTES

1. *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 125 S. Ct. 1627, 161 L. Ed. 2d 577, Blue Sky L. Rep. (CCH) P 74529, Fed. Sec. L. Rep. (CCH) P 93218 (2005).
2. *Ryan v. Flowserve Corp*., 245 F.R.D. 560 (N.D. Tex. 2007).
3. *In re Omnicom Group, Inc. Securities Litigation,* 2008 WL 243788 (S.D. N.Y. 2008).
4. *Dura*, 544 U.S. at 342.
5. *Oscar Private Equity Investments v. Allegiance Telecom, Inc.,* 487 F.3d 261 (5th Cir. 2007). *See* Warren R. Stern & Garrett B. Moritz, "The Fifth Circuit Holds that Loss Causation is a Class Certification Issue," *Securities Litigation Report*, Vol. 4, Issue 7, at 19 (July/August 2007)]; Recent Cases, 121 Harv. L. Rev. 890, 890, 896 (2008) ("This decision reflects a pragmatic and emerging trend in Fifth Circuit jurisprudence after the PSLRA: increasing willingness to restrict class certification in securities cases and, in particular, to limit the scope of the fraud-on-the-market presumption in order to mitigate underlying problems with securities actions," i.e., "the limited ability of such actions to fulfill their intended goals of compensation and deterrence.")
6. Id. at 271.
7. *Flowserve*, 245 F.R.D. at 583.
8. Id.

9. Id. at 573.
10. Id.
11. Id. at 573-574. The court relied on the analysis set forth in Allen Ferrell & Atanu Saha, "The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implication of *Dura Pharmaceuticals v. Broudo,"* The Harvard John M. Olin Discussion Paper Series: http://www.law.harvard.edu/programs/olin_center/.
12. Id. at 581.
13. Id. at 575.
14. Id. at 576.
15. Id. The defendants submitted reports by Lucy P. Allen and Christopher M. James.
16. Id. at 576.
17. Id.
18. Id.
19. Id. at 577.
20. Id. at 580.
21. Id. at 579.
22. *Omnicom*, 2008 WL 243788, at 5.
23. Id. at 6.
24. Id.
25. Id. at 7.
26. Id. at 8.
27. Id.
28. Id.