Loss Causation Update: Corrective Disclosure, Relevant Truth and the *Flowserve* Decision

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This article examines a recent Fifth Circuit decision articulating an approach to loss causation that arguably departs from recent precedent. Loss causation is a central concept in private securities litigation. Proof of loss causation is an essential element of a Rule 10b-5 private securities fraud action, and the *absence* of loss causation is an affirmative defense under §11 and §12 of the Securities Act of 1933. Loss causation turns on the revelation of a prior misrepresentation by a corrective disclosure that causes the share price to decline. Identifying a corrective disclosure may prove challenging, as illustrated by the case discussed in this article, *Alaska Electrical Pension Fund* v. *Flowserve Corp.*[1]

Any discussion of loss causation for purposes of the federal securities laws must start with *Dura Pharmaceuticals, Inc.* v. *Broudo*.[2] There, plaintiffs sued a pharmaceutical company, alleging misrepresentations about profits and pending Food & Drug Administration (FDA) approval of a medical device. The day after the company announced that drug profits would be lower than expected, its share price lost nearly half its value. Months later, the company announced that the FDA did not approve the device. The share price fell the next day, but almost fully recovered within a week.

The district court dismissed the profitability and FDA approval claims on the grounds that plaintiffs failed to plead adequately *scienter* and loss causation, respectively.[3] The Ninth Circuit reversed and remanded, holding that plaintiffs had adequately pleaded loss causation to survive a motion to dismiss.[4] The U.S. Supreme Court granted *certiorari* and reversed and remanded. The Court held that to establish loss causation, plaintiffs had to show that the defendant's misrepresentation or omission proximately caused plaintiffs' economic loss. Thus, the Court explained, plaintiffs could not simply allege their purchase price had been inflated by a misrepresentation. Instead, they had to point to a price decrease that was caused by the revelation of the relevant truth, and not by "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events."[5] In order to establish loss causation, then, plaintiffs would have to show that the corrective disclosure related to the alleged fraud, and that revelation of this fraud—and not the "tangle of factors affecting price"[6]—caused plaintiffs' economic loss.[7] The Court explained that this requirement would be consistent with the objective of the securities laws: "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause."[8]

Ensuring that securities laws do not become a form of investor insurance may come at the expense of protecting investors against fraud. Indeed, *Dura* has been questioned because it may allow management to avoid liability for fraud by strategically timing corrective disclosures. By bundling disclosures, and timing the release of good and bad news, management theoretically may seek to obscure the causal link between a share price decline and the alleged fraud.[9]

Notwithstanding this concern, courts have generally read *Dura* broadly, mindful of what the Fifth Circuit in *Oscar Private Equity Investments* v. *Allegiance Telecom, Inc.* called the "lethal force of certifying a class of purchasers of securities enabled by the fraud-on-the-market doctrine…."[10] Courts have relied on *Dura* to grant summary judgment against plaintiffs when they failed to show that share prices fell because the relevant truth was revealed and not because of other negative news.[11] And some courts have imported the *Dura* standard into rulings on class certification.[12]

Loss causation is clearest when a corrective disclosure—for example, an accounting restatement—reveals a prior misrepresentation and is followed by a price drop not readily explained by other factors. But what if the disclosure is not a *mea culpa*? In such a case, plaintiffs have to show that the relevant truth was revealed to the market[13] and cannot rely on the assertion that the company's "true financial condition" was somehow revealed.[14]

The requirement that a disclosure relate back to the alleged misrepresentation calls for case-by-case analysis. Any such analysis must also confront other questions: Can a disclosure be partial and occur over a period of time rather than be a discrete event?[15] Must a corrective disclosure be made by the same issuer as the prior misstatement, or will third-party revelations suffice?[16] And how public does a disclosure have to be?[17]

Identifying the "relevant truth" is particularly tricky in cases involving a revision of guidance. Is the "relevant truth" the truth that the earlier guidance would not be met or the truth that the guidance was known to be false at the time it was issued?[18] *Flowserve* presents just such a case. Two pension funds brought a class action against pump and valve manufacturer Flowserve Corp., its CEO, its CFO, its auditors and two underwriters of Flowserve stock offers. The action included a Section 10(b) claim against the Flowserve defendants and Section 11 claims against all defendants. The district court denied class certification and granted, in full or in part, motions for summary judgment on the Section 11 claims.[19] Plaintiffs' failure to establish loss causation was central to both decisions.

On appeal, the Fifth Circuit, *per curiam*, reversed in part, vacated in part and remanded for further proceedings. The court held that plaintiffs were not required to show that a revision to an earnings guidance directly revealed the prior guidance to be fraudulent.[20] The panel included Sandra Day O'Connor, Associate Justice of the United States Supreme Court (Ret.), sitting by designation, who had joined the unanimous decision in *Dura*.

The facts giving rise to *Flowserve* are similar to those in *Dura*. In *Flowserve*, plaintiffs ended the class period on the date in which the issuer released lower earnings estimates and the price fell significantly, rather than the later date on which the issuer released news constituting the alleged "truth" and the price moved insignificantly:

- February 6, 2001: Flowserve reports net income for 2000 at $0.35 per share.
- October 22, 2001: Flowserve announces its 2002 earnings guidance of $1.90-$2.30 per share.
- November 16, 2001: Flowserve publicly offers common stock. The registration statement incorporates Flowserve's 2000 Form 10-K that attests to Flowserve's internal controls and contains audited 2000 year-end financial statements and the unqualified audit opinion of PricewaterhouseCoopers (PwC).
- April 16, 2002: Flowserve publicly offers more common stock. The registration statement incorporates Flowserve's 2000 and 2001 Form 10-K, both of which attest to Flowserve's internal controls and contain audited 2000 year-end financial statements and the unqualified audit opinion of PwC.
- July 22, 2002: Flowserve issues a press release initially claimed by plaintiffs to "continue to conceal the truth,"[21] but then later cited by plaintiffs as a corrective disclosure. The press release discloses disappointing earnings for the second quarter of 2002; explains these results by citing weakening demand and currency exchange rates; forecasts the rest of the year as a "mixed picture"; and revises 2002 EPS guidance to $1.70-$1.90 for the full year. The following day, Flowserve's share price falls 37%.
- September 27, 2002: Flowserve issues a press release, initially claimed by plaintiffs to "illustrat[e] continued concealment,"[22] but then later cited by plaintiffs as a correc-

tive disclosure. Flowserve reduces its 2002 EPS guidance to $1.45-$1.55 for the full year, again citing market-related factors. Flowserve's share price falls by approximately 38% at the end of the day.

- August 7, 2003: Plaintiffs file suit against Flowserve.
- February 3, 2004: Flowserve restates its financials for 2000, 2001 and 2002, and the first nine months of 2003, to include aggregate pretax charges and correct inventory and related balances. Flowserve's share price falls by approximately 0.6%.

Plaintiffs sought to maintain the action on behalf of all persons who purchased Flowserve equity securities between February 6, 2001, when Flowserve announced its 2000 financials, and September 27, 2002, when Flowserve reduced its 2002 earnings guidance. During that period, they allege, Flowserve concealed or misrepresented costs associated with two acquisitions; falsely reported financial results; was in violation of its debt covenants; and falsely predicted inflated 2002 earnings. Plaintiffs claimed that these misrepresentations and omissions caused the share price declines that followed Flowserve's guidance revisions of July and September 2002.

Discovery Phase

After extensive discovery, the district court denied class certification on the grounds that plaintiffs had failed to satisfy the Rule 23(b)(3) predominance requirement. In particular, the court found that plaintiffs were not entitled to the presumption of market-wide reliance because they had failed to prove that Flowserve's share price was "actually affected"[23] by the alleged fraud and, indeed, defendants had proved the contrary. To show that Flowserve's share price was "actually affected" by the alleged fraud, the plaintiffs relied on the share price declines following the July and September 2002 guidance revisions and the opinion of a financial economist that those statements revealed the "true financial condition" of Flowserve.

The district court found that the July and September releases had a negative effect on the share price, but not a *corrective* effect; that is, they did not disclose the truth about the alleged fraud.[24] The court reasoned that the truth was revealed to the market in *2004* when Flowserve restated its 2000-2002 financial statements, and not in July and September *2002* when Flowserve merely revised its 2002 earnings guidance. The 2002 statements, the court found, lacked "any tenable relation, general or specific, to dis-synergies, false financials, violations of debt covenants, or optimistic EPS,"[25] and, in fact, made statements "consistent with Plaintiffs' claimed falsehoods."[26] Nor, the court found, did any analyst or other third party reveal any of those matters to the market in 2002. The court faulted plaintiffs' expert for simply assuming that the reduced guidance related to the allegedly concealed integration problems. The court also rejected, as a matter of law, the idea that a price decline following disclosure of financial adversities resulting from fraudulently concealed conduct can be said to have been caused by the fraud even though the conduct itself continued to be concealed.

The district court found that, even if "some related truth did leak out," the defendants had shown that it did not contribute significantly to the July and September 2002 price declines.[27] The court based this finding on event studies submitted by defense experts showing comparable share price declines at peer companies, and on contemporaneous market commentary that attributed the price declines to market and industry factors, missed earnings estimates in the second quarter of 2002 and market overreaction. The court also cited a defense event study showing that the 2004 restatement announcements did not cause statistically significant market price declines. And, the court criticized plaintiffs' expert for disclaiming the need "to distill the effect of the purported corrective disclosure from the effect of the other unrelated revised earnings shortfall in 2002."[28] The district court appeared to be disturbed by the fact that plaintiffs had initially claimed that the 2002 disclosures concealed the truth and then claimed that these disclosures revealed the misstatements and caused the price declines.

The district court concluded by noting that:

> **this action exemplifies the rationale of *Oscar*. Plaintiffs' initial salvo of forceful allegations… drove the litigation through discovery and up to summary judgment. Defendants have borne the financial brunt of 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… . Herein lies the *in terrorem* power of the class action and the extraordinary leverage Plaintiffs wield in this type of litigation, the very essence of the Fifth Circuit's concern in *Oscar*.[29]**

Fifth Circuit Reverses

The Fifth Circuit Court of Appeals disagreed with the district court's analysis. The Fifth Circuit reversed and remanded after attempting to explain the legal standard of "relevant corrective information" when determining loss causation. The court characterized defendants' position—with which it said the district court largely agreed—as requiring a "'fact-for-fact' disclosure of information that fully corrected prior misstatements."[30] The court rejected this standard because it "effectively does away with the fraud-on-the-market theory of reliance" and would allow defendants to "defeat liability by refusing to admit the falsity of its prior misstatements."[31] But the court also labeled as "untenable"[32] plaintiffs' argument that any revelation of a company's "true financial condition," regardless of its relation to prior misstatements, sufficed to show loss causation.

Instead, the Fifth Circuit said that the correct standard lies in the middle:

> **Only information known to the market can cause a loss. For this reason, only information known to the market is relevant under the fraud-on-the-market theory of class wide reliance. …[T]o establish loss causation this disclosed information must reflect part of the "relevant truth"—the truth obscured by the fraudulent statements."[33]**

The court illustrated what it meant to "reflect part of the relevant truth" through reference to the Fifth Circuit's prior decisions in *Greenberg v. Crossroads Systems, Inc.* and *Lormand* v. *US Unwired, Inc.*. In both cases, the court assessed the relationship, if any, between the alleged misstatements and subsequent disclosures, and where there was a sufficient relationship, upheld a presumption of class-wide reliance. [34]

The court of appeals found that the district court had demanded more of plaintiffs than warranted by *Greenberg* and *Lormand*. It concluded that the district court "must have reasoned that the July and September 2002 statements need not have simply reduced Flowserve's earnings-per-share guidance, but had directly to reveal that the October 2001 guidance was fraudulent. That is not required; it was enough that the market learned that the October 2001 guidance was wrong and that other negative information unrelated to the reduced FY2002 guidance did not cause the decline in Flowserve's share price."[35] But the Circuit court then muddled the test by stating that plaintiffs would have to prove that the market learned more than "something is wrong" and would have to show "by a preponderance of the evidence that the market learned more than that Flowserve's earnings guidance was lower and so its business seemed less valuable… ."[36]

The question of class certification has been remanded to the district court to be decided under the standard articulated by the court of appeals. It is not entirely clear, however, what this standard is and, importantly, how it differs from that actually employed by the district court. Although the court of appeals claimed that the district court applied an erroneous "fact-for-fact" standard, the district court had stated that it had *not* read *Dura* as requiring "fact-for-fact" loss causation pleading.[37] And much of its opinion is devoted to the type of analysis the court of appeals endorsed, with consideration of the alleged fraud, the subsequent disclosures and the market's interpretation of these disclosures. The district court found no relationship between the July and September

2002 releases and the alleged fraud through an analysis that relied on *Greenberg*, a case on which the court of appeals also relied.

Flowserve or *Dura*?

It is difficult to reconcile *Flowserve* with *Dura*. Flowserve's earnings revisions disclosed nothing that indicated that prior factual statements were incorrect. No analyst or commentator suggested that the earnings revisions revealed concerns about the accuracy of prior statements by the company. Nothing before the court suggested that, had the timing of the 2002 press releases and 2004 restatement been switched, the market reaction would have been any different.[38] And plaintiffs did not contend that the revised guidance announcements revealed facts that existed at the time of the initial forecast but were knowingly concealed or recklessly disregarded. Indeed, plaintiffs waited nearly a year after the alleged corrective disclosures to commence this action and then maintained that in these disclosures Flowserve *continued* to fraudulently conceal the truth.

One cannot help but suspect that the court of appeals was dissatisfied with a rule that would permit a fraudster to escape liability because of adverse market developments occurring between the fraudulent statement and ultimate correction. Such a rule could reward strategically timing disclosures to occur after price declines caused by market developments and could, in the words of the court, allow defendants to "defeat liability." Indeed, the court of appeals stated that "The Exchange Act is not investor insurance, but neither is the possibility of recovery for fraud tantamount to insurance."[39] This is essentially the policy argument that underlies the "true financial condition" theory of loss causation post-*Dura* that has been criticized by commentators[40] and rejected by other courts.[41] Such a rule, however, seeks to ensure that securities laws do not become a form of investors' insurance that will ultimately deter companies from full disclosure.[42]

Defendants petitioned for a rehearing *en banc* on the grounds that the court of appeals erroneously held that loss causation is established when a forward-looking earnings projection is later revised and this revision results in a stock price fall.[43] The petition was denied. *Flowserve* now returns to the district court, which, unless the parties settle, will have to deal with the apparent contradiction in the court of appeals' statement that "it was enough" that the market learned that the October 2001 guidance was inaccurate but that plaintiffs have to demonstrate that "the market learned more than that Flowserve's earnings guidance was lower and so its business seemed less valuable." Securities litigators will watch with interest to see how the parties and their experts recast their arguments and analyses in light of this standard.[44]

NOTES

1. *Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221, Fed. Sec. L. Rep. (CCH) P 95255, 2009 WL 1740648 (5th Cir. 2009).
2. *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).
3. *In re Dura Pharmaceuticals, Inc. Sec. Litigation*, Fed. Sec. L. Rep. (CCH) P 91,245, 2000 WL 33176043 (S.D. Cal. 2000).
4. *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, Fed. Sec. L. Rep. (CCH) P 92,474 (9th Cir. 2003), judgment rev'd, 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).
5. *Dura,* 544 U.S. at 343.
6. *Dura*, 544 U.S. 336.
7. Plaintiffs typically attempt to isolate the alleged fraud from other potential causal factors by statistical event study analysis. *See* Allen Ferrell and Atanu Saha, *The Loss Causation Requirement for Rule 10B-5 Causes-of-Action: the Implications of Dura Pharmaceuticals* v. *Broudo*, 63 The Business Lawyer 163 (2007).
8. *Dura,* 544 U.S. at 345.
9. *See* James C. Spindler, *Why Shareholders Want Their CEOs to Lie More after Dura Pharmaceuticals* (U.S. Cal. Law Sch. Law and Economics Working Paper Series, Paper No. 59, 2006).
10. *Oscar Private Equity Investments v. Allegiance Telecom, Inc.,* 487 F.3d 261, 262 (5th Cir. 2007) (rejected on other grounds by, *Lapin v. Goldman Sachs & Co.*, 254 F.R.D. 168, Fed. Sec. L. Rep. (CCH) P 94842 (S.D. N.Y. 2008)).

11. *See, e.g., Greenberg v. Crossroads Systems, Inc.*, 364 F.3d 657, Fed. Sec. L. Rep. (CCH) P 92738 (5th Cir. 2004); *In re Williams Securities litigation-WCG Subclass*, 558 F.3d 1130, Fed. Sec. L. Rep. (CCH) P 95069 (10th Cir. 2009); *In re Flag Telecom Holdings, Ltd. Securities Litigation*, 2009 WL 2169197 (2d Cir. 2009).
12. *See Oscar,* 487 F.3d at 262*; In re Initial Public Offering Securities Litigation*, 241 F. Supp. 2d 281, Fed. Sec. L. Rep. (CCH) P 92282 (S.D. N.Y. 2003).
13. *See In re Williams*, 558 F.3d at 1140 ("To be corrective, the disclosure need not precisely mirror the earlier representation, but it must at least relate back to the misrepresentation and not to some other negative information about the company.").
14. Under the "true financial condition" theory, an investor can claim inflationary loss when share prices fall following the release of any negative news. This negative news reveals the company's true financial condition otherwise concealed by the fraud, and as such, the fraud ultimately caused the negative news and subsequent price decline. "Market forces operating on the fraud" is a related theory. *See* Madge S. Thorsen *et al.*, *Rediscovering the Economics of Loss Causation* 6 J. Bus. & Sec. 93 (2005-2006); Ferrell and Saha, *supra*, at 173-175.
15. *See Lormand v. US Unwired, Inc.*, 565 F.3d 228, 261, Fed. Sec. L. Rep. (CCH) P 95205 (5th Cir. 2009).
16. Some Second Circuit decisions suggest that analyst reports can constitute corrective disclosures. *See, e.g., In re eSpeed, Inc. Securities Litigation*, 457 F. Supp. 2d 266, Fed. Sec. L. Rep. (CCH) P 93827 (S.D. N.Y. 2006); *In re Winstar Communications*, 2006 WL 473885 (S.D. N.Y. 2006).
17. *See Hunt v. Enzo Biochem, Inc.,* 530 F. Supp. 2d 580, 597 (S.D. N.Y. 2008)(holding that a disclosure is sufficiently public if it reaches "a substantial segment of the institutional investment community.").
18. *See* Private Securities Litigation Reform Act of 1995, 15 U.S.C.A. § 78u-4 (2008).
19. *Ryan v. Flowserve Corp.*, 245 F.R.D. 560 (N.D. Tex. 2007), rev'd in part, vacated in part, 572 F.3d 221, Fed. Sec. L. Rep. (CCH) P 95255 (5th Cir. 2009).
20. The court also held that plaintiffs bear the burden of establishing loss causation by a preponderance of the evidence at the class certification stage; that a genuine issue of material fact existed as to whether the company's statement revising prior projected earnings caused some portion of the loss; and that the district court erroneously placed the burden of proving loss causation on the plaintiffs for §11 claims.
21. *Ryan*, 245 F.R.D. at 564 n.8. The district court notes that in their Fifth Amended Complaint, plaintiffs maintained that in these two press releases, Flowserve "continued to conceal the truth… but that the content of the releases deflated shareholders' expectation…."
22. *Ryan*, 245 F.R.D. at 572.
23. *Ryan*, 245 F.R.D. at 568.
24. *Ryan*, 245 F.R.D. at 579.
25. *Ryan*, 245 F.R.D. at 572.
26. *Ryan*, 245 F.R.D. 560.
27. *Ryan*, 245 F.R.D. at 576.
28. *Ryan*, 245 F.R.D. at 577.
29. *Ryan*, 245 F.R.D. at 583.
30. *Alaska*, 2009 WL 1740648 at *6.
31. *Alaska*, 2009 WL 1740648.
32. *Alaska*, 2009 WL 1740648 at *7.
33. *Alaska*, 2009 WL 1740648.
34. In *Greenberg*, the court analyzed the series of misrepresentations and corresponding corrective disclosures and price declines alleged by plaintiffs, and rejected as inactionable those alleged misrepresentations to which later negative news "made no reference." *Greenberg* 364 F.3d at 667. In *Lormand*, plaintiffs alleged loss causation from two sets of misrepresentations, but the court dismissed one, finding that none of the disclosures "plausibly suggests" that a significant part of the price decline was caused by that alleged misrepresentation. *Lormand* 565 F.3d at 260.
35. *Alaska*, 2009 WL 1740648 at *8.
36. *Alaska*, 2009 WL 1740648 at *9.
37. *Ryan*, 245 F.R.D. at 575.
38. *See* Ferrell and Saha, *supra*, at 172.
39. *Alaska*, 2009 WL 1740648 at *8. This concern was again raised during oral arguments, in particular by Justice O'Connor (Ret.).
40. *See* Ferrell and Saha, *supra*, at 173-175.
41. *See In re Retek Inc. Securities Litigation*, 621 F. Supp. 2d 690, Fed. Sec. L. Rep. (CCH) P 95269 (D. Minn. 2009); *In re William*, 558 F.3ds at 1140; *In re Worldcom, Inc. Securities Litigation*, 2005 WL 2319118 (S.D. N.Y. 2005).
42. *See, e.g., Raab v. General Physics Corp.*, 4 F.3d 286, 290, Fed. Sec. L. Rep. (CCH) P 97713 (4th Cir. 1993) (noting that "predictions on future growth… will almost always prove to be wrong in hindsight… . Imposing liability would put companies in a whipsaw, with a lawsuit almost a certainty. Such liability would deter companies from discussing their prospects, and the securities markets would be deprived of the information those predictions offer.").
43. Def. Appellant's Pet. Reh'g En Banc, July 3, 2009.

44. As this article was going to press, the Fifth Circuit handed down another loss causation decision, *Fener v. Belo Corp.*, 2009 WL 2450674 (5th Cir. Aug. 12, 2009). This time, the court affirmed a denial of class certification because the plaintiff had failed to prove through a statistical analysis that a stock price decline following an announcement of reduced performance expectations was caused by the disclosure that a portion of the reduction was attributable to the discovery and cessation of fraudulent practices rather than other adverse factors disclosed in the same press release. The opinion compared class certification in securities class actions to "a shakedown," and distinguished *Lormand*, on which *Flowserve* heavily relied, as limited to consideration of loss causation allegations at the pleading stage.