NEW YORK CITY BAR
Securities Litigation
During the Financial Crisis:
Current Developments & Strategies

DAMAGES AND LOSS CAUSATION

By Alex Sussman

December 8, 2009

Introduction

- Focus on the typical Rule 10b-5 securities fraud class action, governed by the Private Securities Litigation Reform Act of 1995 ("PSLRA") with special reference to the financial crisis.
- Governing principles and methods of establishing:
  - Loss causation: Since 2005 Supreme Court decision in Dura, one of the most heavily litigated issues.
  - Damages: Critical to the strategy and outcome.
Loss Causation –
PSLRA and Dura Pharmaceuticals


- *Dura* held that the allegation that stock was purchased at an allegedly inflated price due to a fraudulent misrepresentation does not, in itself, adequately plead loss causation.

Connecting Fraud to the Loss

- “To prove loss causation, a plaintiff must demonstrate ‘that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security.’” *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 574 F.3d 29 (2d Cir. 2009), quoting *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161 (2d Cir. 2005).

- Plaintiff must show that (1) “the market reacted negatively to a corrective disclosure” or (2) defendants “misstated or omitted risks that did lead to the loss,” i.e. materialization of a concealed risk. *Lentell*, 396 F.3d at 173.
Loss Causation Complaint
Allegations – Does Rule 9(b) Apply?

- *Dura* assumed the Rule 8 notice pleading standard applies to allegations of loss causation.

- However, the issue remains unsettled. *In re Gilead Sciences Sec. Litig.*, 536 F.3d 1049 (9th Cir. 2008); see *In re First Union Sec. Litig.*, 2006 U.S. Dist. LEXIS 5083, *17-*18 (W.D.N.C. Jan. 20, 2006) (citing cases applying Rule 9(b)).

- A Fifth Circuit panel applied Rule 8(a)(2) to require the plaintiff to allege “a facially ‘plausible’ causal relationship between the fraudulent statements or omissions and plaintiff’s economic loss.” *Lormand v. US Unwired, Inc.*, 565 F.3d 228 (5th Cir. 2009).

Loss Causation Complaint
Allegations – Does Rule 9(b) Apply? (cont’d)

- In *McAdams v. McCord*, 2009 U.S. App. LEXIS 22830, *4, *7 (8th Cir. Oct. 20, 2009), the court affirmed dismissal of a PSLRA claim against an outside auditor on loss causation grounds because a PSLRA “complaint must state with particularity the circumstances of the alleged fraudulent statement” and this complaint did not “specify how two statements by [the outside auditor] . . . proximately caused the investor’s losses.”

- In *Teachers’ Ret. Sys. v. Hunter*, 477 F.3d 162, 186 (4th Cir. 2007), the court observed that there is a “strong case” for applying Rule 9(b) to loss causation allegations, but instead required “sufficient specificity to enable the court to evaluate whether the necessary causal link exists.”
Loss Causation – A Necessary Element for Class Certification?

- In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), the Fifth Circuit ruled that plaintiffs must establish loss causation in order to obtain class certification.
  - Plaintiffs bear the burden of establishing it by “a preponderance of the evidence.” *Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221 (5th Cir. 2009) (reversing district court’s dismissal of case).

Loss Causation in Section 11 Cases

- Section 11(e) of the Securities Act of 1933, 15 U.S.C. § 77k(e), provides a “negative causation” affirmative defense to claims that a Registration Statement was materially misleading.
  - In *Flowserve, supra*, the Ninth Circuit reversed a summary judgment dismissal that found “negative causation.”
  - *In re Britannia Bulk Holdings Inc. Sec. Litig.*, 08 Civ. 9554 (DLC) (S.D.N.Y. Oct. 19, 2009): Claim dismissed based on negative causation as misstatement was post-IPO and stock had dropped 90% before corrective disclosure.
Loss Causation – Financial Crisis Issues

- Was the investor’s loss caused by the misrepresentation or, rather, by “changed economic circumstances, new industry-specific or firm-specific facts, conditions, or other events,” which account for the lower stock price? *Dura*, 544 U.S. at 352-53.
  - Demonstrating loss causation is more difficult if “plaintiff’s loss coincides with a market-wide phenomenon.” *Lentell v. Merrill Lynch*, 396 F.3d at 174.
- Was the stock price drop caused by unanticipated business losses resulting from the financial crisis?
- Did a sub-prime finance company’s losses result from the decline in home prices or from “corrective disclosure” or “materialization of risk” as to previously undisclosed mortgage problems?

No Loss Causation – No Connection Between Fraud and Loss

- Loss causation allegations fail if they are “conclusory and involve unreasonable inferences.” *In re Redback Networks, Inc. Sec. Litig.*, 329 Fed. Appx. 715 (9th Cir. 2009).
- Plaintiffs failed to plead loss causation where they did not “allege that Deloitte’s misstatements concealed the risk of Warnaco’s bankruptcy.” *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 157 (2d Cir. 2007).
- Rule 10b-5 claim failed because fraudulent representation that an investor was accredited did not cause any loss. *ATSI Commc’ns, Inc. v. The Shaar Fund, Ltd.*, 493 F.3d 87 2d (2d Cir. 2007).
No Loss Causation –
Shares Sold Prior to Corrective Disclosure

- The Second Circuit excluded from a certified class in-and-out traders and others who sold their shares prior to the first corrective disclosure. *In re Flag Telecom, supra.*

No Loss Causation –
Fraud Revealed After Unrelated Price Decline

- No loss causation where price dropped after bankruptcy announcement and plaintiff never alleged that “market’s acknowledgement of prior misrepresentations caused that drop.” *D.E. & J. Ltd. P’ship v. Conaway*, 133 F. App’x 994, 1000 (6th Cir. 2005).
No Loss Causation
Price Drops on Unrelated Bad News

- *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1064 (9th Cir. 2008): Revised forecast caused loss, not because of “revelation” of alleged fraud, but because “the company failed to hit prior earnings estimates.”
- *In re Tellium, Inc. Sec. Litig.*, 2005 WL 2090254, at *3-4 (D.N.J. Aug. 26, 2005): Announcement that revenues were lower than expected was held not to be a corrective disclosure, because the bad news did not disclose the fraud.

Loss Causation Shown –
Materialization of the Concealed Risk

- Generally, if there is no corrective disclosure, the necessary materialization of risk is “sudden and caused the stock value to plummet.” *In re Rhodia S.A. Sec. Litig.*, 2007 U.S. Dist. LEXIS 72758 (S.D.N.Y. Sept. 26, 2007) (certain claims dismissed).
- For example, in *In re Parmalat Securities Litigation*, disclosure of a bond default was held to be the materialization of the alleged fraudulent scheme. 375 F. Supp. 2d 278, 284 (S.D.N.Y. 2005).
Loss Causation Shown – 
Materialization of the Concealed Risk (cont’d)

- Stock price decline following disclosure of accounting problems was held to be the materialization of risk from concealed internal control deficiencies. *In re Scottish Re Group Sec. Litig.*, 2007 U.S. Dist. LEXIS 81565, *59-62 (S.D.N.Y. Nov. 2, 2007).


No Loss Causation – 
No Concealed Risk Nor Corrective Disclosure

- Estimated $200 million jury verdict was overturned because the court found that analyst reports “did not provide any fraud-revealing analysis” and were therefore not “corrective.” *In re Apollo Group, Inc. Sec. Litig.*, 2008 WL 3072731, at *3 (D. Ariz. Aug. 4, 2008)

- Claims against accounting firm for allegedly false audit opinions concerning AOL were dismissed to the extent they neither concealed any undisclosed risk nor were ever corrected. *In re AOL Time Warner, Inc. Sec. Litig.*, 503 F. Supp. 2d 666, 677-80 (S.D.N.Y. 2007)
Selected Cases –
Loss Causation Allegations Sufficient


Event Studies Assessing
Loss Causation and Damages

- Event studies may be used to prove or disprove loss causation by providing a methodology for analyzing company-specific stock price movements.

- “The tool most often used by experts to isolate the effect of a corrective disclosure on the stock price is the ‘event study.’” *Apollo, supra*, at n. 1.

- In the Fifth Circuit, in support of a motion for class certification, “the testimony of an expert--along with some kind of analytical research or event study--is required to show loss causation.” *Fener v. Belo Corp.*, 579 F.3d 401 (5th Cir. 2009)
Event Studies – Methodology and Use

- Components and methodology of event studies:
  - Regression analysis of stock price changes
  - Adjust for marketwide and industrywide stock price changes, unrelated to fraud
  - Identify company-specific price movements

Integrated Chronology

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<th>Date</th>
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*Time's still time to catch a Rene.*

- Baby Alliance: KephyNet Medical Management, Fort Lauderdale, saw 11% to $17.25 after the company entered into a 15-year agreement to provide physician management services to Physician Care of America, a health care provider in Miami. Terms of the agreement weren't disclosed. (Source: The Wall Street Journal)
Possible Attacks on Event Studies

- **Fener v. Belo Corp., supra:** The Fifth Circuit rejects “any event study that shows only how a ‘stock reacted to the entire bundle of negative information,’ rather than examining the ‘evidence linking the culpable disclosure to the price movement.’” (quoting *Oscar* at 271).

- **In re Xcelera.com Sec. Litig., No. 00-11649-RWZ (D. Mass. April 25, 2008):** The court granted a *Daubert* motion precluding testimony of plaintiff’s expert (and later summary judgment dismissal), because event study was flawed, including omission of stock price rise on first trading day following the first corrective disclosure.

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Expert Opinions Showing Loss Causation

- Plaintiffs won summary judgment using an event study showing loss causation in *Gaming Lottery Sec. Litig.*, 2001 U.S. Dist. LEXIS 2034 (S.D.N.Y. Mar. 1, 2001)

Failure of Expert to Show Loss Causation

- Summary judgment dismissal affirmed where plaintiff’s expert’s methods did not “reliably link the class’s losses to the revelation of the alleged misrepresentations, as *Dura* requires.” *In re Williams Sec. Litig. – WCG Subclass*, 558 F.3d 1130, 1137 (10th Cir. 2009).
- Plaintiffs offered no expert testimony or other evidence to show loss causation, where the stock price had collapsed before alleged fraud was revealed. *Ray v. Citigroup Global Markets, Inc.*, 2005 U.S. Dist. LEXIS 24419, at *11 (N.D. Ill. Oct. 18, 2005), aff’d, 482 F.3d 991 (7th Cir. 2007).
Defense Expert May Disprove Loss Causation

- “Defendants’ expert’s event study proved that none of the alleged misstatements . . . had an effect on the stock price.”

Damages

- No express measure of damages under Section 10(b)
- Section 28(a) provides that recovery shall not exceed a plaintiff’s “actual damages”
Damages Measure in Section 10(b)  
“Fraud on the Market” Cases

  - Amount overpaid by stock *purchasers* because stock price was artificially inflated by alleged misrepresentation or omission; or
  - Amount lost by stock *sellers* because stock price was artificially deflated by alleged misrepresentation or omission

Aggregate Damages in Class Action

- Multiply: Per share damages (generally determined by event studies)
- Times: Number of shares damaged (plaintiffs offer stock trading models/defendants may object)
- PSLRA provides “bounce-back” rule which caps per-share damages by the excess of purchase price over post-disclosure average price (to the earlier of sale or 90 days). See 15 U.S.C. §78u-4(e)
Determining Per-Share Damages During Class Period

- Per-share damages: The difference between “true value” of stock and actual price paid by buyer
- Generally, plaintiffs argue that stock price decline after corrective disclosure reflects amount price was inflated
- Proving damages can be a “daunting task”-- usually a “battle of experts,” In re Microstrategy Sec. Litig., 150 F.Supp. 2d 896 (E.D. Va. 2001)

Event Studies Necessary to Calculate Per Share Damages

- Need to factor out extraneous factors and isolate effect of fraud on stock price
- Damage calculations have been rejected for failure to conduct an event study, e.g., In re Imperial Credit Indus.; Executive Telecard Sec. Litig., 979 F. Supp. 1021 (S.D.N.Y. 1997); Oracle Sec. Litig., 829 F. Supp. 1176 (N.D. Cal. 1993)
- Where regression analysis was not feasible, event study was not required in RMED Int’l v. Sloan’s, 2000 U.S. Dist. LEXIS 3742 (S.D.N.Y. Mar. 24, 2000)
Calculating Number of Damaged Shares

- How many shares were purchased during class period and still held at end of class period?
- Plaintiffs’ experts use stock trading models based upon key assumptions
- The calculation can vary widely depending upon the model and the assumptions, *e.g.*, in the *Apollo* case, plaintiffs had estimated that damaged shares numbered between 30- and 50-million shares.
**Stock Trading Model**

- Estimate float available for trading by class members by making adjustments to total outstanding shares
- Estimate total shares traded by class members by making adjustments to reported trading volume
- Assume trading pattern: Determine number of retained shares that are damaged

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**Stock Trading Models – Typical Adjustments to Float and Trading Volume Inputs**

- **Float adjustments**
  - Institutional investors that do not trade during the damage period (-)
  - Insider holdings (-)
  - Company stock in 401(k) plan (-)
  - Short interest (+)
- **Trading volume adjustments**
  - Double counting in the reported volume due to market maker activity (-)
  - Short sellers covering positions (-)
  - Changes in insiders holdings (-)
  - Stock buybacks (-)
  - Lower float or trading volume results in fewer retained shares and lower damages
Types of Stock Trading Models

- Proportional Trading Model (PTM)
  - Typical original plaintiff-style model
  - Assumes every share is equally likely to trade
- Accelerated Trading Model (ATM)
  - Generally lower damages than PTM
  - Assumes shares traded since beginning of class period are more likely to trade than shares that have not traded during class period
- Two Trader Model (TTM)
  - Modified plaintiff-style model
  - Generally lower damages than PTM
  - Assumes one class of shares ("Traders") has a much higher likelihood of trading than other class of shares ("Investors")

Example of PTM Trading Damages Analysis

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Stock Trading Models Generate Substantial Differences in Estimated Damages

Example:
Total Float Available for Trading: 1,000,000 shares
Daily Trading Volume: 10,000 shares / day
Inflation Per Share: $5/share (constant dollar inflation)
Class Period Length: 90 days

Proportional
$3.0 million

Accelerated
$1.9 million

Two-Trader
$1.8 million

Source: B. Stangle and G. Jetley, Analysis Group, Inc.
Notes: Accelerated Trading Model assumes previously traded shares are 5 times more likely to trade than untraded shares. Two-Trader Model assumes high-intensity "traders" hold 20% of the float and account for 80% of daily volume, and low-intensity "investors" hold 80% of the float and account for 20% of daily volume.

Example of PTM Trading Damages Analysis (cont'd)

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Total | 12,581,866 | 44,675,287 | 4,192,515 |
Some Court Opinions Have Rejected Trading Models

One court has ruled that the PTM was inadmissible under Daubert, see Kaufman v. Motorola, 2000 U.S. Dist. LEXIS 14627 (N.D. Ill. Sept. 21, 2000)

- Plaintiffs’ expert testified that the PTM:
  - “Had never been tested against reality”
  - “Never accepted by professional economists”

- Effect: Jury would determine per-share damages, rather than aggregate damages

- In Apollo, supra, the jury had determined a per-share damage amount rather than a total damage award

Some Court Opinions Have Rejected Trading Models (cont’d)

One court has ruled that the Two Trader Model is of “significantly questionable reliability” and “probably does not satisfy the Daubert test.” In re Broadcom Corp. Sec. Litig., 2005 U.S. Dist. LEXIS 12118, at *8-9 (C.D. Cal. June 3, 2005).

- The court ruled that a jury determination of the per-share damage per day combined with use of the claims administration process was more accurate and reliable.

- Broadcom cites other courts that rejected trading models, 2005 U.S. Dist. LEXIS 12118, at *4-7
Other Courts Have Accepted Trading
Models or Other Proof of Aggregate Damages

- In *In re Worldcom, Inc. Sec. Litig.*, 2005 U.S. Dist. LEXIS 3143 (S.D.N.Y. Mar. 3, 2005), evidence of aggregate damages was allowed, but no stock trading model was at issue.


- Some courts view criticisms of PTM as going to weight and credibility, rather than admissibility, e.g., *In re Cendant Corp. Sec. Litig.*, 109 F. Supp. 2d 235 (D.N.J. 2000)

Conclusion

- Securities fraud cases present loss causation and damage issues that invite creative legal and economic analysis.

- Expert witnesses and studies play an important role in analyzing and presenting arguments on those issues.