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Loss Causation Experts After Dura

Law360, New York (May 21, 2009) -- A crucial element of any securities class action — especially one that survives an initial motion to dismiss — is the role of the expert witness on loss causation.

The strength of the causation and damages model presented by the expert — who is frequently the same expert to testify on market efficiency in a fraud-on-the-market case — may be critical to plaintiffs' ability to survive class certification and summary judgment.

Moreover, the parameters of any possible settlement may be influenced more by the expert than by other elements of the plaintiffs' case, given the tendency of settlements to turn more on the scope of realistically possible damages than on the merits.

It is only very recently that a body of law has begun to develop regarding loss causation experts under the Supreme Court's 2005 decision in *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336 (2005), culminating with the first federal appellate opinion directly addressing the admissibility of a loss causation expert's testimony.

The Tenth Circuit in *In re Williams Secs. Litig. - WCG Subclass*, 558 F.3d 1130 (10th Cir. 2009), found a plaintiffs' expert's testimony inadmissible — and granted summary judgment to the defendants — because the expert did not make the evidentiary connections required under *Dura* to support his conclusions.

This article will look at the intersection of legal and practical issues in challenges to a plaintiffs' loss causation expert and how those issues were addressed in *Williams*.

Loss Causation Under Dura

Traditionally, expert testimony on loss causation has focused on calculating “inflation:” how much higher a stock's trading price was, at any given point in time, than it “should” have been but for an alleged fraud.[1]

Damages models generally proceed on the premise that the plaintiff is harmed by paying an inflated price to purchase the stock, which the plaintiff is unable to recoup by selling the stock at a later date. Proving the amount of inflation can itself trip up experts who fail to establish some basis for computing the “fraud-free” or “but for” price of the stock.[2]

The Supreme Court, in *Dura*, held that in addition to showing inflation at the time of purchase, a plaintiff must clear two further hurdles of proof: first, the plaintiff must show that the stock’s price declined “after the truth ma[de] its way into the market place.” *Dura*, 544 U.S. at 342.

Second, the plaintiff must show that the decline was not caused by some factor other than the defendant’s fraud, such as “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events.” *Id.* at 343.

As the Second Circuit has noted, in a multi-defendant case those other circumstances may include “much more consequential and numerous” misrepresentations by other defendants.[3]

Corrective Disclosure

Dura’s first requirement has been heavily litigated. Many cases involve allegations that the stock price declined due to a “corrective disclosure” that explicitly revealed some previously concealed or misrepresented fact.

Most courts accept that whether a disclosure is corrective is properly determined by the court on a motion to dismiss or at summary judgment by comparing the plaintiffs’ allegations of fraud with the subsequent public disclosure and the market’s reaction, none of which require extensive discovery.

Experts may nonetheless face challenges to their selection of corrective disclosures. Some are the same hurdles that arise at the pleading stage — for example, courts have found that particular disclosures did not really include new information.[4]

The *Williams* court buttressed this conclusion with the testimony of the plaintiffs’ expert, who was unable to explain how the plaintiffs’ attorneys could assemble a complaint “on the very day of the first corrective disclosure” if those facts were not already known to the market.[5]

In other cases, experts have found themselves unable to identify when or how a disclosure revealed a particular fact.[6] In one case, the reliability of an expert’s selection of relevant event days in his event study was challenged because he omitted a date that he admitted included a corrective disclosure.[7]

“Leakage” and “Materialization of Risk”

To prove loss causation where no corrective disclosure can be identified, plaintiffs commonly try two variations on the same theme.

One, seizing on Dura’s statement that there is no loss if “the purchaser sells the shares before the relevant truth begins to leak out,” Dura, 544 U.S. at 342, is to argue that declines in the issuer’s stock price constituted frequent or even continuous “leakage” of the truth into the marketplace.

Where the stock price declines gradually over a protracted period, a “leakage” theory — if accepted — would enable plaintiffs to claim damages for virtually every day in the class period on which the price declined. Williams was a test case for this theory. The stock price of the issuer, WCG, had declined steadily and precipitously along with the market for telecom stocks in general.

The plaintiffs contended that, in light of the issuer’s misrepresentations of its “true financial condition,” the stock had been effectively worthless from the outset of its IPO, creating a “risk” that “materialized” as it suffered continuing financial reverses and ultimately bankruptcy.

The plaintiffs’ expert presented as his most aggressive scenario the theory that nearly the entire decline in the value of WCG’s stock was recoverable as damages. The Tenth Circuit, while acknowledging that leakage could theoretically occur, rejected it in the absence of proof of how:

To satisfy the requirements of Dura ... any theory — even a leakage theory that posits a gradual exposure of the fraud rather than a full and immediate disclosure — will have to show some mechanism for how the truth was revealed ... A plaintiff cannot simply state that the market had learned the truth by a certain date and, because the learning was a gradual process, attribute all prior losses to the revelation of the fraud. The inability to point to a single corrective disclosure does not relieve the plaintiff of showing how the truth was revealed; he cannot say, “Well, the market must have known.” Williams, 558 F.3d at 1138.

The court’s emphasis on the “mechanism” for leakage is critical at the summary judgment stage. If a plaintiff’s expert cannot explain and demonstrate how market participants learned of the truth and acted on it on each of the days in question, the expert’s theory of leakage is simply speculation and inadmissible.

More broadly, courts have increasingly recognized that whether or not plaintiffs pursue a corrective disclosure theory, their proof must ultimately include a showing that the market learned the truth^[8] and did so before, not after, a decline in price.^[9]

Plaintiffs often argue that a concealed risk “materialized” through subsequent adverse events, generally when a company announced poor financial results that are alleged to reveal the company’s previously fraudulently concealed “true financial condition.”

The district court in *Williams* faulted the use of this theory where the plaintiffs could not show how or when the market learned the truth: “[t]he concept of materialization of the risk ... is method of proof of loss causation, not an excuse for lack of evidence of loss causation.” *In re Williams Secs. Litig.*, 496 F. Supp. 2d 1195, 1265 (N.D. Okla. 2007).

The Tenth Circuit agreed that “any theory of loss causation would still have to identify when the materialization occurred and link it to a corresponding loss,” and was unpersuaded that invoking the theory allows a plaintiff to treat all inflation-causing events as causes of the company’s failure so long as they relate broadly (as all material events do) to the company’s financial health:

“[t]he zone of risk ... is not infinite in size ... there are simply too many potential intervening causes to say that bankruptcy was WCG’s legally foreseeable destiny such that its trading price at bankruptcy equaled its true value on the day the spinoff was announced.” *Williams*, 558 F.3d at 1138, 1142-43.

Other courts of appeal have likewise rejected pleadings that failed to squarely allege when and how the “relevant truth” became “generally known” to the market,[10] or proof at summary judgment that an undisclosed condition was “putting a strain on [the issuer’s] already-struggling finances, thus potentially contributing to the ... plaintiffs’ economic loss” without proving that it caused that loss.[11]

Excluding Other Causes

The second part of *Dura*’s test — the ability to exclude other causes for the decline — has posed particular problems for plaintiffs’ experts, especially when dealing with company-specific information, despite the judicial expectation that “[s]orting out which declines were caused by such extraneous factors and which were caused by a materialization of the concealed risk is generally the province of the expert.” *Vivendi*, 2009 WL 920259, at *10.

While most expert event studies measure stock price movements against market or industry indices in an effort to control for those variables (with varying degrees of success), courts have regularly faulted plaintiffs’ experts for making little or no effort to account for other factors.

The court in *Williams* found that the failure to even attempt to exclude other identifiable causes rendered the expert’s opinion unreliable. See *Williams*, 558 F.3d at 1139, 1141-42. Other courts have reached similar conclusions, whether on a motion to exclude the expert,[12] at class certification,[13] or on summary judgment.[14]

Conclusion

The bases for challenging loss causation experts are not limited to those listed above; in particular cases, there may be a variety of available challenges to the reliability of an expert's methods as applied to the facts. But Williams makes clear that, at a minimum, an expert's loss causation opinions must meet the standards of proof required by Dura.

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[1] This article discusses loss causation in the context of stocks. Additional issues are presented by claims involving debt securities, which may be traded in much thinner markets and may react differently to the same news.

[2] See, e.g., McCabe v. Ernst & Young LLP, 494 F.3d 418, 432-33 (3d Cir. 2007); Morgan Stanley & Co. v. Coleman (Parent) Holdings Inc., 955 So.2d 1124, 1127-29 (Fla. App. 4th Dist. 2007).

[3] Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147, 158 (2d Cir. 2007). See also In re AOL Time Warner Inc. Secs. Lit., 503 F. Supp. 2d 666, 679-80 (S.D.N.Y. 2007).

[4] See, e.g., In re Apollo Group Inc. Secs. Litig., No. CV 04-2147, 2008 WL 3072731, at *3 (D. Ariz. Aug. 4, 2008); In re Omnicom Group, Inc. Secs. Litig., 541 F. Supp. 2d 546, 551-54 (S.D.N.Y. 2008).

[5] Williams, 553 F.3d at 1141.

[6] See, e.g., In re Retek Inc. Secs. Litig., Civ. No. 02-4209, 2009 WL 928483, at *18 (D. Minn. Mar. 31, 2009).

[7] See In re Xcelera.com Secs. Litig., Civ. A. No. 00-11649-RWZ, slip opinion, at 2 (D. Mass. Apr. 25, 2008).

[8] See, e.g., In re Vivendi Universal, S.A. Secs. Litig., No. 02 Civ. 5571, 2009 WL 920259, at *9-10 (S.D.N.Y. Mar. 31, 2009); Retek, 2009 WL 928483, at *11-12; Ryan v. Flowserve Corp., 245 F.R.D. 560, 579 (N.D. Tex. 2007); McKowan Lowe & Co. v. Jasmine Ltd., No. Civ. 94-5522 et al, 2005 WL 1541062, at *9 & n. 10 (D.N.J. June 30, 2005), aff'd, 231 Fed. App'x. 216 (3d Cir. Aug. 17, 2007).

[9] See, e.g., Ray v. Citigroup Global Mkts., 482 F.3d 991, 995-96 (7th Cir. 2007).

[10] See, e.g., *Metzler Inv. GmbH v. Corinthian Coll's Inc.*, 540 F.3d 1049, 1064-65 (9th Cir. 2008); *Teachers' Ret. Sys. v. Hunter*, 477 F.3d 162, 186-88 (4th Cir. 2007); *Tricontinental Indus. Ltd. v. PricewaterhouseCoopers LLP*, 475 F.3d 824, 843 (7th Cir. 2007).

[11] *McCabe*, 494 F.3d at 436-37.

[12] See *Xcelera*, slip op. at 4-5.

[13] See *Oscar Private Equity Inv. v. Allegiance Telecom Inc.*, 487 F.3d 261, 270 (5th Cir. 2007).

[14] See *Omnicom*, 541 F. Supp. 2d at 554. See also *Ray*, 482 F.3d at 995 (failure to offer rebuttal to defendant's expert); *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657, 667 (5th Cir. 2004) (summary judgment where expert failed to exclude other causes of inflation).