

'Materialization Of Risk' In Securities Class Actions: Part 2

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In [part one of this two-part series](#), we discussed how plaintiffs asserting claims for securities fraud under Section 10(b) of the Securities and Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, increasingly invoke the “materialization of risk” theory of loss causation. This is particularly the case when plaintiffs cannot plead a clear “corrective disclosure” — i.e., a statement that reveals that some prior disclosure was false or misleading and, as a consequence, negatively affects the value of a security. The materialization of risk theory allows plaintiffs to instead allege that a risk that the defendants fraudulently concealed eventually came to light in a series of revealing events (rather than disclosures), which negatively affected the stock price over time.

Our first article analyzed the origins and development of the theory and its treatment at the motion to dismiss stage. Here in part two, we explore litigants’ and courts’ treatment of the theory at the class certification, summary judgment, and trial phases of a securities class action.

Class Certification Phase

Once a class action complaint for violations of Section 10(b) and Rule 10b-5 has survived a motion to dismiss, a plaintiff will then seek to certify the putative class. Under FRCP Rule 23(a), a class action must meet four requirements: (1) numerosity of the class members; (2) the existence of common issues; (3) that the class representative’s claims are typical; and (4) that the class representative will adequately represent the class. In addition, a class action for damages must show that common issues predominate over individual issues. “Rule 23 does not set forth a mere pleading standard. A party seeking class certification must affirmatively demonstrate his compliance with the Rule — that is, he must be prepared to prove that there are *in fact* sufficiently numerous parties, common questions of law or fact, etc.”[1]

The [U.S. Supreme Court](#) held in 2011, in *Erica P. John Fund Inc. v. Halliburton Co.* (“Halliburton I”), that a plaintiff need not show loss causation at the class certification stage, rejecting an idiosyncratic rule of the Fifth Circuit that had made proof of loss causation a prerequisite to invoking the “fraud on the market” presumption of reliance.[2] But Halliburton I did not eliminate the role of the loss causation issue at the class certification stage, which may surface in a number of ways.

First, loss causation may be relevant to whether the class representatives’ claims are typical of the class, and whether they will adequately represent the class (an issue that is sometimes raised by competing plaintiffs at the outset of a securities class action, when the court is appointing lead plaintiffs under the Private Securities Litigation Reform Act). If there are multiple potential dates when compensable losses may have occurred, a class representative who sold early in the class period — in some cases, before any corrective

disclosure or materialization of the risk — could be subject to unique loss causation defenses, or might not adequately represent class members who are more interested in proving causation from later events.[3] In some cases, there may even be intractable conflicts between plaintiffs who sold early and those who bought late and have antagonistic interests in showing when losses were caused. Precisely because materialization of risk cases often involve less clear and obvious corrective disclosure dates, there may be more room for debate between different plaintiffs' litigation strategies, and thus larger potential issues with typicality, adequacy and intra-class conflict.

Second, when the Supreme Court returned to the Halliburton case in 2014, it held that a defendant may rebut the “fraud on the market” presumption of reliance at the class certification stage — and thus defeat class certification, which is premised upon common proof of reliance — by showing that the alleged misrepresentation or omission had no impact on the market price of the stock.[4] Moreover, a plaintiff may not even invoke the presumption without showing that the market for the security reacted efficiently to news, which generally requires proof that the price reacted to disclosures of news.[5] While these inquiries focus on the time of purchase, in many cases — such as Halliburton itself — the plaintiffs' evidence that the stock price reacted to news, and that the price was inflated by fraud, is drawn heavily from the price decline from which the plaintiffs seek damages. The Eighth Circuit, in *IBEW Local 98 Pension Fund v. Best Buy Co.*, denied class certification on the grounds that the defendant had shown that the stock price was not inflated by statements on a conference call, but rather by a nonfraudulent press release — and rejected the plaintiffs' effort to show that the “price drop after the ... ‘corrective disclosure’ was evidence of the requisite price impact.”[6] But in cases where a defendant's showing of an alternative cause at the time of the misstatement is less compelling, the market reaction at the time of the price decline may be more hotly contested.

Third, the Supreme Court held in its 2013 decision in *Comcast Corp. v. Behrend* that, because a plaintiff must satisfy Rule 23(b)(3)'s predominance requirement “through evidentiary proof,” a plaintiff seeking to certify a class bears the burden to proffer a damages model “establishing that damages are capable of measurement on a classwide basis.”[7] Such a damages model necessarily implicates the question of when and how plaintiffs intend to prove that damages were caused, and courts have long rejected proposed classes where it was not clear that all members of the class could prove economic loss by common proof.[8] Plaintiffs do not need to prove damages at the class certification stage, just as they do not need to prove loss causation — but their model must be methodologically sound, and simply demonstrating how they intend to do so may expose individual issues and class conflicts.

The Fifth Circuit, in *Ludlow v. BP PLC*, rejected a proposed class pursuing a materialization-of-risk theory of loss causation, finding that its proposed damages model failed Comcast's test in two ways.[9] *Ludlow* arose from the catastrophic 2010 Deepwater Horizon oil spill; the plaintiffs alleged that the oil company defendant “misstated the efficacy of its safety procedures, creating an impression that the risk of a catastrophic failure was lower than it actually was.”[10] The plaintiffs' theory of concealed risk assumed that “each plaintiff would not have bought BP stock *at all* were it not for the alleged misrepresentations.”[11] As the court noted, however, some class members would doubtless have bought the stock — albeit at lower prices — if they had known the true risk, and class members “cannot be compensated for the materialization of a risk [they] may have been willing to take.”[12] As

the court observed, if the true risk of an oil spill was 2 percent and the market price assumed that it was 0.5 percent, the true damages should be assessed as if the risk was 2 percent — not 100 percent, which is what it appeared to be in hindsight after the spill: the concealed zone of risk was “the true risk of an accident in the Gulf — as distinguished from that risk’s impact on [the defendant’s] stock *price*.”[13]

The first way in which this use of a materialization of risk theory presented problems for class certification was that it created a “windfall” for some class members, those who would have bought the stock anyway, even if at a different price; only those who would not have bought at all could plausibly seek the full damages for a spill’s effect on the stock.[14] The second way is even more fundamental: investors who would not have accepted the risk at any price were not relying on the market price at all, but rather “that their investment decisions were based substantially on factors other than price” and so could not invoke the fraud on the market theory.[15]

The plaintiffs’ theory in *Ludlow* may not be the usual approach of plaintiffs in materialization of risk cases, but its outcome illustrates how the need to produce an explicit theory of causation and damages after *Comcast* can present unique problems for class actions premised on this theory. Indeed, while the Fifth Circuit cautioned that it was not ruling on the viability of the materialization of risk theory as a pathway to showing loss causation, it distinguished cases upholding the theory: “suffice to say that these cases did not directly address class certification in a post-*Comcast* world.”[16]

Summary Judgment Phase

Even where allegations of materialization of risk survive a motion to dismiss, they may still fall short at the summary judgment stage if the evidence (including expert evidence) does not support the allegations. Such evidence must be forthcoming even if the security does not trade in an efficient market, and thus the price does not react reliably to news — after all, if there is no resulting decline, there is no loss.[17] In particular, courts have granted summary judgment when the plaintiffs’ experts were unable to present reliable, admissible testimony identifying when and how the risks materialized and disentangling losses caused by fraud from losses caused by nonfraudulent market forces or company-specific events.[18] At summary judgment, “[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.”[19]

The Second Circuit, in *In re Omnicom Group Inc. Securities Litigation*, upheld summary judgment in favor of the defendants where the company’s stock price dropped when a director resigned, and the plaintiff “has at best shown that [the director’s] resignation and resulting negative press stirred investors’ concerns that other unknown problems were lurking in [the company’s] past.”[20] But unlike the complaint in *Daou* that tied such concerns to specific market skepticism of the company’s past financial statements, the evidence in *Omnicom* showed that the resignation was tied to publicly known losses from an acquisition, not concealed accounting malfeasance: “the facts were known a year before the resignation, and the resignation did not add to the public knowledge any new material fact about the ... transaction.”[21] The fact that the market reacted out of fear of an unknown shoe dropping was not enough: “[f]irms are not required by the securities laws to speculate

about distant, ambiguous, and perhaps idiosyncratic reactions by the press or even by directors.”[22]

By contrast, in *In re Lehman Brothers Securities* and ERISA Litigation, the court denied summary judgment for the auditors for a failed investment bank even where the bank’s failure had occurred at the epicenter of a massive financial crisis and “loss causation [was] not obvious in this case.”[23] The plaintiffs’ theory was that repurchase agreement transactions had been misleadingly accounted for in the bank’s financials, concealing the bank’s risk exposure.[24] The court was unwilling to require a “one-to-one” relationship between the concealment and the ultimate cause of the loss, and found sufficient evidence presented to show that the bank’s “collapse flowed from investor panic over the quality of its balance sheet, and [the repo transactions] allegedly aimed to make, and in any event allegedly made, that balance sheet look healthier than it arguably was.”[25]

Trial Phase

While few securities class actions go to trial, those that do often involve complex and contested theories of loss causation. A handful of circuit court opinions in recent years have followed class plaintiffs’ verdicts on loss causation.[26]

Procedurally, for a securities fraud trial to manage issues of price inflation and loss causation, the jury must be given detailed special verdict forms allowing them to identify the misstatements and the amount of fraud-caused inflation in the stock on the various days of the class period.[27] As at summary judgment, the plaintiff must present admissible evidence (typically including expert testimony) attributing the losses to the concealed risk’s materialization or disclosure, and distinguishing it from other causes. In *Hubbard v. BankAtlantic Bancorp Inc.*, the Eleventh Circuit affirmed judgment as a matter of law for the defendants because the plaintiffs’ expert — who testified that the entire decrease in a bank’s stock price resulted from the materialization of concealed risks in its real estate loan portfolio — failed to account for an intervening and publicly disclosed cause, i.e., the collapse of the Florida real estate market.[28] By contrast, the Second Circuit in *In re Vivendi SA Securities Litigation*, and the Seventh Circuit in *Glickenhau & Co. v. Household International Inc.*, both had evidence of company witnesses and documents attributing the losses to the concealed risk,[29] as well as expert testimony that sought to isolate the effects of the fraud.[30] The Seventh Circuit in *Glickenhau* found it “reasonable to expect the defendants to shoulder the burden of identifying some significant, firm-specific, nonfraud related information that could have affected the stock price,” but ordered a new trial because the expert’s testimony distinguishing those factors was too general.[31]

Ultimately, the materialization of risk theory has been accepted in many courts with significant reservations, and its viability depends on the courts being reassured that those reservations are addressed at every stage of the litigation. Thus, while the courts are hesitant to exclude from Section 10(b)’s coverage the fact patterns that cause plaintiffs to invoke the theory (especially in class actions), those fact patterns also present particular issues of pleading and proof at each stage of the case.

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[1] [Wal-Mart Stores](#), Inc. v. Dukes, 564 U.S. 338, 350 (2011) (emphasis in original).

[2] Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. 804, 811-13 (2011).

[3] See, e.g., In re Flag Telecom Holdings, Inc. Sec. Litig., 574 F.3d 29, 41 (2d Cir. 2009) (rejecting “in-and-out traders” who sold before the first corrective event as class representatives); In re [Moody's Corp.](#) Sec. Litig., 274 F.R.D. 480, 487-88 (S.D.N.Y. 2011) (same).

[4] Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2416 (2014) (“Halliburton II”).

[5] See, e.g., [Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.](#), 546 F.3d 196, 207-08 (2d Cir. 2008).

[6] IBEW Local 98 Pension Fund v. Best Buy Co., 818 F.3d 775, 782-83 (8th Cir. 2016).

[7] Comcast Corp. v. Behrend, 133 S. Ct. 1426, 1432-33 (2013).

[8] See, e.g., In re Rail Freight Fuel Surcharge Antitrust Litig., 725 F.3d 244, 252-53 (D.C. Cir. 2013) (model must “show all class members suffered *some* injury”) (emphasis in original); Newton v. [Merrill Lynch](#), Pierce, Fenner & Smith, Inc., 259 F.3d 154, 186-93 (3d Cir. 2001).

[9] Ludlow v. BP, P.L.C., 800 F.3d 674 (5th Cir. 2015).

[10] Id. at 689.

[11] Id. at 690 (emphasis in original).

[12] Id.

[13] Id. at 691 (emphasis in original).

[14] Id. at 690.

[15] Id. at 691.

[16] Id. at 690 n.68.

[17] Nuveen Mun. High Income Opportunity Fund v. City of Alameda, 730 F.3d 1111, 1119 (9th Cir. 2013).

[18] See, e.g., Nuveen, 730 F.3d at 1122-23; In re Williams Sec. Litig.-WCG Subclass, 558 F.3d 1130, 1138-39 (10th Cir. 2009); McCabe v. [Ernst & Young LLP](#), 494 F.3d 418, 436-37 (3d Cir. 2007) (noting absence of testimony from company executive attributing the stock price decline to the alleged concealed risk).

[19] Williams, 558 F.3d at 1138.

[20] In re Omnicom Group, Inc. Sec. Litig., 597 F.3d 501, 514 (2d Cir. 2010).

[21] Id.

[22] Id.

[23] In re Lehman Brothers Sec. & ERISA Litig., 131 F. Supp. 3d 241, 264 (S.D.N.Y. 2015).

[24] Id.

[25] Id. at 265.

[26] See In re Vivendi, S.A. Sec. Litig., 838 F.3d 223, 260-63 (2d Cir. 2016) (upholding plaintiffs' jury verdict); Glickenhau & Company v. Household International, Inc., 787 F.3d 408, 415-24 (7th Cir. 2015) (upholding most of plaintiffs' jury verdict, but remanding on specific issues); Hubbard v. BankAtlantic Bancorp, Inc., 688 F.3d 713, 727-30 (11th Cir. 2012) (affirming judgment as a matter of law for defendant following plaintiffs' jury verdict).

[27] See, e.g., Vivendi, 838 F.3d at 238; Glickenhau, 787 F.3d at 414, 417; Hubbard, 688 F.3d at 722-23.

[28] See Hubbard, 688 F.3d at 727-30.

[29] See Vivendi, 838 F.3d at 263; Glickenhau, 787 F.3d at 420.

[30] See Vivendi, 838 F.3d at 262-63; Glickenhau, 787 F.3d at 421-22.

[31] Glickenhau, 787 F.3d at 421-23.