'Materialization Of Risk' In Securities Class Actions: Part 1

By **Dorothy Spenner, James Heyworth, Daniel McLaughlin and Ariel Atlas**

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Private securities fraud lawsuits are designed to recover losses caused by fraud — not as a system of investor insurance. Congress, in 1995, amended the Securities and Exchange Act of 1934 to codify the rule that "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate [Section 10(b)] caused the loss for which the plaintiff seeks to recover damages."[1] To sue for securities fraud under Section 10(b) and Rule 10b-5, a plaintiff must therefore plead and prove, among other things, that (1) the defendant made a materially false or misleading statement (or omission) and (2) the misrepresentation or omission not only caused the plaintiff to invest, but also caused the economic loss the plaintiff seeks to recover — i.e., loss causation.

The most direct way to show loss causation is a corrective disclosure: a "misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security."[2] The market was told something that was false, and the price went up; then the market was told the truth and the price went down. But what if there's no statement that explicitly corrects the falsehood?

In such cases, plaintiffs often invoke the "materialization of risk" theory, allowing them to allege that a concealed risk "c[a]me[] to light in a series of revealing events that negatively affect stock price over time."[3] Some courts have treated this as the equivalent of a corrective disclosure for loss causation purposes, finding that "events constructively disclosing the fraud,"[4] led to "negative investor inferences" that "caused the loss and were a foreseeable materialization of the risk concealed by the fraudulent statement."[5] While the federal circuit courts remain divided on this theory, a majority have held that some form of materialization of risk can show loss causation. As the plaintiffs' bar has increasingly used the materialization of risk theory as a substitute for corrective disclosures, however, a number of courts have balked at broad readings of the theory.

This two-part article discusses how the materialization of risk theory plays out at the various phases of a securities fraud action. In Part I, below, we explain the theory and its treatment

at the motion to dismiss stage. In the forthcoming Part II, we explain litigants' and courts' treatment of the theory at the class certification, summary judgment, and trial phases of a securities class action.

Materialization of Risk Theory

While it was once an open question whether loss causation was a necessary statutory element of a Section 10(b) claim, the U.S. Supreme Court held in 2005 in Dura Pharmaceuticals Inc. v. Broudo that plaintiffs must not only prove loss causation but also plead facts showing it in their complaint.[6] The Dura court specifically required a complaint to plead that the company's "share price fell significantly *after* the truth became known" but *before* the plaintiff sold the stock.[7] The court cautioned, however, that "[w]hen the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but 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."[8]

A corrective disclosure neatly fits the Dura court's description, but the court's opinion also refers to selling after "the relevant truth begins to leak out" or "after the truth makes its way into the market place" — references that have been read by some courts to approve of methods of informing the market other than an explicit corrective disclosure.[9] When there are no statements on or around the time of the stock drop that disclose that prior statements or omissions were false or misleading, complaints instead invoke a series of events that are claimed to reveal any number of previously concealed risks.

The term "materialization of risk" derives from a pre-Dura Seventh Circuit case, Bastian v. Petren Resources Corp., in which Judge Richard Posner theorized that loss causation could be found in assurances explicitly downplaying an investment's risks (assurances that were absent in Bastian).[10] It was adopted by the Second Circuit to address a second fact pattern: negotiated transactions that led to losses when concealed prior deficiencies of the issuer's management — such as a prior pattern of "pump-and-dump" schemes — repeated themselves.[11] The most influential explanation of the theory comes from the Second Circuit in Lentell v. Merrill Lynch & Co., a case decided shortly before Dura, which dismissed claims that investor losses were caused by risks concealed by securities analysts

who touted stocks without disclosing their own conflicts of interest:

> We have described loss causation in terms of the tort-law concept of proximate cause ... [A] misstatement or omission is the "proximate cause" of an investment loss if the risk that caused the loss was within the zone of risk concealed ... [A] plaintiff must allege ... that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered, ... i.e., that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security. Otherwise, the loss in question was not foreseeable.
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> ... [T]he pleading principles set out in the foregoing passage require both that the loss be foreseeable *and* that the loss be caused by the materialization of the concealed risk ... If the significance of the truth is such as to cause a reasonable investor to consider seriously a zone of risk that would be perceived as remote or highly unlikely by one believing the fraud, and the loss ultimately suffered is within that zone, then a misrepresentation or omission as to that information may be deemed a foreseeable or proximate cause of the loss.[12]

Courts have been skeptical of efforts to paint the materialization of risk theory as a separate path to prove loss causation, with one district court describing it as a "method of proof of loss causation, not an excuse for lack of evidence of loss causation."[13] The Second Circuit has stressed that "our past holdings do not suggest that 'corrective disclosure' and 'materialization of risk' create fundamentally different pathways for proving loss causation," and that they "are not wholly distinct theories of loss causation."[14] The Seventh Circuit has gone further, describing it as "not a legal doctrine ... [t]he phrase adds nothing to the analysis."[15] Some circuits have explicitly reserved the question of the doctrine's viability.[16] Some have endorsed it explicitly,[17] or seemed to do so implicitly.[18] The Fifth Circuit, as noted below, has gone the furthest in questioning the doctrine's viability, at least in class action cases.[19] Thus, while materialization-of-risk cases may present somewhat distinct fact patterns, the essential requirements of pleading and proof that apply in corrective disclosure cases must still be satisfied.

Pleading/Motion to Dismiss Phase

While the court in Dura did not resolve exactly what standard of pleading is required, it held that, even under the minimum standard imposed by Rule 8 of the Federal Rules of Civil Procedure, a conclusory allegation alone that the investor's purchase price was "inflated" by fraud is not enough; there must be "some indication of the loss and the causal connection that the plaintiff has in mind."[20] There remains no consensus among the circuits as to

whether the Rule 9(b) or a similar standard is required, or only Rule 8.[21]

Regardless of which method is used to allege loss causation or what standard applies, defendants often challenge the pleading of loss causation at the motion to dismiss stage. Defendants make a number of different arguments, including that (1) the plaintiff does not point to a moment in time when the "truth" was revealed to the market[22]; (2) the plaintiff has not shown a significant stock price movement associated with the revelation of the truth[23]; (3) the plaintiff has failed to plead facts that exclude other likely explanations for their losses, such as a financial downturn or poor financial conditions of the stock issuer, or has failed to provide any basis for distinguishing the loss from such causes[24]; (4) the corrective disclosure or materializing event was not actually a revelation of the particular concealed fact; or (5) the concealed fact had actually been revealed earlier or was never really concealed.[25] Each of these arguments is equally applicable to materialization-of-risk cases, in particular the first and fourth: that plaintiffs have failed to show that the materializing event actually manifested the concealed risk and was understood by the market as such.

Whether these arguments are successful is a case-by-case determination that depends on the facts alleged, but courts following Dura have not been shy about dismissing complaints that failed to satisfy its pleading standard. Courts are more apt to find a materialization of risk from a sudden and massive event such as a "liquidity crisis" tied to massive overstatement of the company's cash position.[26] Where there is no clear corrective disclosure, courts may look for factual allegations demonstrating that the market understood that the risk had materialized. In In re Daou Systems Inc. Securities Litigation, for example, the company "dramatically missed its projected [quarterly] earnings," and that led analysts to question the company's prior financial reports, which had cannibalized later earnings by prematurely recognizing revenue — the complaint quoted one analyst commenting, "*You have got to question whether they are manufacturing earnings.*"[27] In the absence of such a market acknowledgement, the passage of time and intervening market events make courts more skeptical of equating later setbacks with concealment of earlier conditions.[28] However, courts will often place the onus on defendants to identify such intervening events if none are apparent from the complaint.[29]

Dorothy J. Spenner and James Heyworth are partners, Daniel McLaughlin is a counsel, and Ariel Atlas is an associate with Sidley Austin LLP in New York. They are members of Sidley's securities and shareholder litigation group.

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[1] 15 U.S.C. § 78u-4(b)(4).

[2] Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005).

[3] In re Vivendi Universal, S.A., Sec. Litig., 765 F. Supp. 2d 512, 555 (S.D.N.Y. 2011), aff'd, 838 F.3d 223 (2d Cir. 2016).

[4] In re Vivendi Universal, S.A., Sec. Litig., 838 F.3d 223, 262 (2d Cir. 2016) ("Vivendi II").

[5] In re Omnicom Group, Inc. Sec. Litig., 597 F.3d 501, 511 (2d Cir. 2010).

[6] Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005).

[7] Id. at 342-43, 347 (emphasis added).

[8] Id. at 342-43.

[9] Id. at 342.

[10] See Bastian v. Petren Resources Corp., 892 F.2d 680, 686-87 (7th Cir. 1990) (Posner, J.); see also Ray v. Citigroup Global Mkts. Inc., 482 F.3d 991, 995-97 (7th Cir. 2007) ("it would be necessary for a broker to use very explicit language before loss causation could be proved this way").

[11] See Suez Equity Inv'rs, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 98 & n.1 (2d Cir. 2001); see also Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 197-98 (2d Cir. 2003).

[12] Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173-74 (2d Cir. 2005) (emphasis in original; citations and quotations omitted).

[13] In re Williams Sec. Litig., 496 F. Supp. 2d 1195, 1265-66 (N.D. Okla. 2007), aff'd, 558 F.3d 1130 (10th Cir. 2009).

[14] Vivendi II, 838 F.3d at 261-62.

[15] Schleichler v. Wendt, 618 F.3d 679, 683-84 (7th Cir. 2010).

[16] See, e.g., Ludlow v. BP, P.L.C., 800 F.3d 674, 690 n.68 (5th Cir. 2015); Nuveen Mun. High Income Opportunity Fund v. City of Alameda, 730 F.3d 1111, 1122 n.5 (9th Cir. 2013); Hubbard v. BankAtlantic Corp., 688 F.3d 713, 726 n.25 (11th Cir. 2012); Teachers' Ret. Sys. of La. v. Hunter, 477 F.3d 162, 187 n.3 (4th Cir. 2007).

[17] See Ohio Pub. Emps. Ret. Sys. v. Fed. Home Loan Mortg. Corp., 830 F.3d 376, 385 (6th Cir. 2016); Nakkhumpun v. Taylor, 782 F.3d 1142, 1156 (10th Cir. 2015).

[18] See Mass. Ret. Sys. v. CVS Caremark Corp., 716 F.3d 229, 241-43 (1st Cir. 2013).

[19] See Ludlow, 800 F.3d at 690-91.

[20] Dura, 544 U.S. at 347.

[21] Compare Oregon Pub. Emps. Ret. Fund v. Apollo Grp. Inc., 774 F.3d 598, 605 (9th Cir. 2014) ("Rule 9(b) applies to all elements of a securities fraud action, including loss causation."); Katyle v. Penn Nat. Gaming, Inc., 637 F.3d 462, 471 (4th Cir. 2011) (applying "a standard largely consonant with" Rule 9(b)); Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP, 475 F.3d 824, 842 (7th Cir. 2007) with Lormand v. U.S. Unwired, Inc., 565 F.3d 228, 258 (5th Cir. 2009) (applying Rule 8). See also Nakkhumpun, 782 F.3d at 1153-54 (reserving question); CVS Caremark, 716 F.3d at 239 n.6 (same).

[22] See, e.g., Metzler Inv. GmbH v. Corinthian Colls., Inc., 540 F.3d 1049, 1064-65 (9th Cir. 2008); Tricontinental, 475 F.3d at 843.

[23] See, e.g., GE Inv'rs v. Gen. Elec. Co., 447 Fed. Appx. 229, 231-32 (2d Cir. 2011) ("zone of risk" concealed was issuance of new equity, but market price did not react to that – only to further announcement of a lower price than expected, which was already a known

risk once new issuance was announced).

[24] See Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147, 158 (2d Cir. 2007) (dismissing complaint against outside auditor that failed to "allege[] facts that would allow a factfinder to ascribe some rough proportion of the whole loss to [the auditor's] misstatements," especially in light of "much more consequential and numerous" misrepresentations by the issuer); In re AOL Time Warner, Inc. Sec. Litig., 503 F. Supp. 2d 666, 679-680 (S.D.N.Y. 2007).

[25] See, e.g., Teachers' Ret. Sys. of La. v. Hunter, 477 F.3d 162, 187-89 (4th Cir. 2007).

[26] Compare In re Parmalat Sec. Litig., 375 F. Supp. 2d 278, 284 (S.D.N.Y. 2005) (finding materialization of risk from such a "liquidity crisis") with In re Rhodia, S.A. Sec. Litig., 531 F. Supp. 2d 527, 546 (S.D.N.Y. 2007) ("slow, steady decline" that "pinpoints no such incident" not a materialization of risk).

[27] In re Daou Sys., Inc., Sec. Litig., 411 F.3d 1006, 1026 (9th Cir. 2005) (emphasis in original).

[28] See, e.g., Schaaf v. Residential Funding Corp., 517 F.3d 544, 552-53 (8th Cir. 2008) (passage of five months between alleged breach of debt-to-worth covenants and lenders' declaration of default and foreclosure on debentures following failure to deliver information and pay interest).

[29] See, e.g., Nakkhumpun, 782 F.3d at 1156.