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Loss Causation: A Significant New Burden

Monday, Apr 07, 2008 --- Two decisions issued recently by the U.S. Court of Appeals for the Fifth Circuit and a third issued by the U.S. District Court for the Southern District of New York have imposed a significant new burden on plaintiffs seeking class certification in securities fraud cases.

Those decisions, Luskin v. Intervoice-Brite Inc.,[1] Oscar Private Equity Investments v. Allegiance Telecom Inc.,[2] and In re Credit Suisse First Boston Corp. (Lantronix, Inc.) Analyst Securities Litigation,[3] require plaintiffs attempting to satisfy the “predominance” requirement of Federal Rule of Civil Procedure 23(b)(3) to establish, at the class certification stage, that the allegedly false or misleading statements from which their claims arise caused a decline in the price of their securities.

That is, Luskin, Oscar Private Equity and In re Credit Suisse expressly require plaintiffs, for the first time, to demonstrate “loss causation” as a prerequisite to class certification.

While of recent vintage, this requirement is a logical outgrowth of the U.S. Supreme Court’s 2005 decision in Dura Pharmaceuticals, Inc. v. Broudo,[4] which resolved a circuit court split over the precise meaning of “loss causation” in the securities fraud context.

Dura held that to maintain a Section 10(b) claim a “plaintiff must prove that the defendant’s misrepresentation (or other fraudulent conduct) proximately caused the plaintiff’s economic loss.”[5]

In so holding, the Supreme Court rejected the Ninth Circuit’s more permissive loss causation formula which required only a showing that “a misrepresentation le[d] to an inflated purchase price but nonetheless [did] not proximately cause any economic loss.”[6]

But the triumvirate of recent decisions pushes the holding of Dura a significant step beyond loss causation, and establishes a burden that plaintiffs may find difficult to meet at the class certification stage, before the parties have had the benefit of full discovery.

Moreover, while consistent with the holding of Dura, these recent decisions may clash with the policy underpinnings of the class action vehicle by erecting a significant new hurdle to class certification.

Federal Rule of Civil Procedure 23(b)(3) and the Fraud-on-the-Market Presumption of Reliance

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In addition to the requirements of Federal Rule 23(a), federal court litigants seeking class certification must satisfy one of the three requirements of Federal Rule 23(b).

In disclosure-based securities fraud cases in particular, which usually arise from a finite group of allegedly false or misleading public statements, plaintiffs typically rely on the third subsection of Rule 23(b), which requires parties seeking class certification to establish, among other things, that "questions of law or fact common to the members of the class predominate over any questions affecting only individual members."[7]

In common parlance, this is the "predominance" requirement of Rule 23(b)(3).

To satisfy this requirement, the party seeking certification must show that the legal and factual issues raised by the proposed action that are subject to "generalized proof outweigh those issues that are subject to individualized proof."[8]

This means the movant bears the burden of proving that the proposed class members' legal and factual claims are more alike than different, thus justifying the amalgamation of multiple claims in a single action.

Many courts presiding over securities fraud class actions based on a single or handful of related disclosures find that Rule 23(b)(3) predominance is "easily met" due to common class-wide questions such as defendants' knowledge of the alleged misstatements or omissions.[9]

However, in securities fraud class actions that include claims under Section 10(b) of the Securities Exchange Act, as most do, the predominance requirement of Federal Rule 23(b)(3) bumps up against problems of reliance and causation peculiar to that Exchange Act section, and requires more careful scrutiny.

In any Section 10(b) action arising from allegedly false or misleading statements (or omissions), a plaintiff is required to prove that he or she relied on the defendant's alleged misrepresentations.

Given the sheer size of most shareholder classes, however, "establishing reliance individually by members of the class would defeat the requirement of Rule 23[(b)(3)] that common questions of law or fact predominate over questions affecting only individual members."[10]

Stated differently, were securities plaintiffs required to prove that each class member relied on a given false or misleading statement, the court would, in effect, be obligated to conduct numerous "mini-trials" aimed at establishing, on a case-by-case basis, each class member's reliance—thus eliminating the efficiencies that justify class treatment in the first place.

As a result, plaintiffs seeking certification of large shareholder classes usually

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attempt to establish reliance by invoking the so-called “fraud-on-the-market” presumption of reliance, the rebuttable presumption “that the price of an actively traded security in an open, well-developed and efficient market reflects all the available information about the value of a company.”[11]

Pursuant to this theory, an investor who relies on a security’s market price in making an investment decision necessarily relies indirectly on any misrepresentations or omissions incorporated into that price, and need not prove direct reliance on any given misstatement or omission.

The fraud-on-the-market presumption is not new. It was sanctioned by the Supreme Court twenty years ago in Basic Inc. v. Levinson,[12] and is today a staple of securities class action litigation.

The interplay between the fraud-on-the-market presumption and the newly-minted definition of loss causation, however, is a comparatively novel issue that could, if tested in the right procedural posture, derail shareholder class actions before plaintiffs are able to take advantage of (and defendants must pay for) full-blown discovery.

Loss causation as defined in Dura is a cornerstone of the fraud-on-the-market presumption because the theory underlying the presumption presupposes that public misrepresentations and subsequent corrective information demonstrably impact a security’s market price.

If such misrepresentations have no measurable impact on market price, shareholders cannot be said to have relied on a price distorted by misinformation.

Add to the loss causation requirement the predominance requirement of Rule 23(b)(3), which requires a common basis for establishing reliance, and the fraud-on-the-market presumption becomes a factual obstacle to class certification nearly as impassable as the individual reliance problem it was meant to remedy.

Recent Judicial Interpretations of Rule 23(b)(3) in Securities Class Actions

It is the tangle resulting from the intersection of loss causation, the fraud-on-the-market theory and Rule 23(b)(3)’s predominance requirement that the three recent decisions cited above seek to unravel.

The elements comprising the tangle are not new: the fraud-on-the-market theory has been in general circulation since Basic, and loss causation has been an express requirement of all private securities fraud cases since the passage of the Private Securities Litigation Reform Act of 1995.[13]

One recent catalyst of the new decisions was Dura itself, which settled the meaning of “loss causation” in the securities fraud context. Another was the 2003 amendments to Federal Rule 23, which arguably expanded the permissible scope of a district court’s inquiry into whether a party has

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satisfied the requirements of the rule.

As summarized by the Civil Rules Advisors Committee, after the amendments, a "court that is not satisfied that the requirements of Rule 23 have been met should refuse certification until they have been met."[14]

In the Second Circuit's formulation, a proper analysis of Federal Rule 23 now requires a "definitive assessment" of the requirements of Rule 23, "notwithstanding their overlap with merits issues."[15]

After Dura, the Fifth Circuit was the first court to explicitly diagram the proper relationship between loss causation, the fraud-on-the-market theory and Rule 23(b)(3)'s predominance requirement in the securities class action context.

In Oscar Private Equity Investments v. Allegiance Telecom Inc., the court considered Section 10(b) claims brought by shareholders of Allegiance Telecom Inc., based on allegedly false statements made in the company's quarterly public filings.

The appellate court vacated and remanded the district court's order certifying a class of Allegiance shareholders, holding that the class "fail[ed] for wont of any showing that the market reacted to the corrective disclosure" that the class members claimed had caused their losses.[16]

"[O]bserv[ing] that Basic [v. Levinson] allows each of the circuits room to develop its own fraud-on-the-market rules," the Fifth Circuit used the opportunity Oscar presented "to tighten the requirements for plaintiffs seeking a presumption of reliance" by "requir[ing] more than proof of a material misstatement."[17]

After Oscar, litigants in the Fifth Circuit must "pro[ve] that the [defendant's] misstatements actually moved the market."[18]

Stated simply, Oscar "require[s] plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption."[19]

Moreover, like the Second Circuit in Initial Public Offering, the Oscar court emphasized that the 2003 amendments to Federal Rule 23 provided district courts greater latitude to assess the strength of a plaintiff's fraud-on-the-market claims at the class certification stage, and that such preliminary scrutiny is warranted because "a district court's certification order often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that precedes it."[20]

Any lingering questions about whether Oscar was an aberration were laid to rest earlier this year by the Fifth Circuit's follow-up decision in Luskin v. Intervoice-Brite Inc.

The district court in Luskin certified a class of Intervoice-Brite Inc. shareholders over defendants' objection that plaintiffs had failed to show loss

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causation and, thus, failed to meet the predominance requirement of Federal Rule 23(b)(3).

In support of its order, the district court reasoned, “an examination of the [fraud-on-the-market] presumption at the class certification stage would be premature and improperly delve into the actual merits of Plaintiffs’ claims.”[21]

The Fifth Circuit vacated and remanded the district court’s certification order “for a determination of whether Plaintiffs have demonstrated loss causation sufficiently to invoke the fraud-on-the-market presumption.”[22]

In doing so, the Luskin court affirmed the requirement established in Oscar that, at the class certification stage, “the district court [must] examine whether the Plaintiffs have adequately demonstrated loss causation by a preponderance of all admissible evidence before permitting Plaintiffs to invoke the fraud-on-the-market presumption.”[23]

Finally, in February 2008, District Judge Loretta A. Preska weighed in with an opinion in In re Credit Suisse First Boston Corp. (Lantronix Inc.) Analyst Securities Litigation, that established the new trend begun by Oscar.

In In re Credit Suisse, the court granted defendants’ motion to decertify a class of Lantronix, Inc. shareholders due to plaintiffs’ failure to establish loss causation at the class certification stage.

Relying on the Second Circuit’s decision in In re Initial Public Offering, the court held that, given the “absence of market impact” resulting from defendants’ allegedly false and misleading statements, “the Basic [v. Levinson] presumption is not properly applicable here and ... Plaintiff has not carried his burden of demonstrating that the elements of Rule 23(b) have been satisfied.”[24]

In so ruling, the court left no doubt that the Second Circuit now requires a resolution of the loss causation question at the class certification stage, and that a finding of loss causation is an indispensable element of the fraud-on-the-market presumption.[25]

Loss Causation And The Class Action Vehicle

Internally, the reasoning employed in Oscar, Luskin and In re Credit Suisse is sound. Guided by the Supreme Court’s holding in Dura, each decision simply carries the holding of Basic to its logical conclusion.

What is less clear is whether requiring a party seeking class certification to demonstrate loss causation at the class certification stage furthers or hinders the policy goals underlying the class action vehicle.

As one court noted, “Class actions serve an important function in our judicial system. By establishing a technique whereby the claims of many individuals

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can be resolved at the same time, the class suit both eliminates the possibility of repetitious litigation and provides small claimants with a method of obtaining redress for claims which would otherwise be too small to warrant individual litigation."[26]

Securities class actions in particular are important because "it is widely believed that such suits deter wrongdoing and promote integrity and efficiency of the capital markets."[27]

And as many courts have observed, given their inherent complexity, securities fraud cases are particularly well suited to class treatment.[28]

If one agrees that class actions are an efficient means of resolving certain kinds of legitimate shareholder claims and promote the integrity and efficiency of the securities markets, does requiring a preliminary showing of loss causation present an unwarranted barrier to such claims?

At first blush, the answer appears to be "yes." Requiring plaintiffs to make what is often a fact-intensive demonstration of loss causation before full discovery, seems to present a hurdle to certification at odds with the policy goals of the class action vehicle.

After all, loss causation is an element of any prima facie Section 10(b) claim; if a plaintiff cannot make the requisite loss causation showing after certification his claim will be dismissed at that time. It thus seems that a loss causation inquiry at the class certification stage is premature.

Two considerations, however, compel the opposite conclusion.

First, as discussed above, the recent amendments to Federal Rule 23 permit courts to make a more searching inquiry into the merits of the fraud-on-the-market theory at the class certification stage.

Because loss causation can usually be proved or disproved by a combination of publicly available information and expert testimony, and because courts often allow limited discovery into issues bearing on class certification, plaintiffs now have ample opportunity to gather and present the evidence necessary to make a loss causation showing without the need for full discovery.

Second, despite the passage of the PSLRA, many unfounded securities cases still manage to make it past the motion to dismiss stage. An additional check at the class certification stage will serve the necessary function of weeding out bad claims.

Thus, the new loss causation requirement furthers the policy goals underlying shareholder class actions by hastening the identification and resolution of legitimate suits (thereby expediting their deterrent impact and, by extension, promoting the integrity of the capital markets), and by promoting the efficiency of the capital markets by eliminating the

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unnecessary costs to issuers of defending baseless shareholder suits.

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[1] No. 06-11251, 2008 WL 104273 (5th Cir. Jan. 8, 2008).

[2] 487 F.3d 261 (5th Cir. 2007).

[3] No. 03 Civ. 2467(LAP), 2008 WL 512779 (S.D.N.Y. Feb. 26, 2008).

[4] 544 U.S. 336 (2005).

[5] Id. at 346.

[6] Id.

[7] Fed. R. Civ. P. 23(b)(3).

[8] Heerwagen v. Clear Channel Commc'n, 435 F.3d 219, 226 (2d Cir. 2006).

[9] See, e.g., Omnicom Group, Inc. Sec. Litig., No. 02 Civ. 4483 (RCC), 2007 WL 1280640, at *7 (S.D.N.Y. Apr. 30, 2007).

[10] In re Initial Public Offering Sec. Litig., 471 F.3d 24, 41 (2d Cir. 2006).

[11] Freeman v. Laventhol & Horwath, 915 F.2d 193, 197 (6th Cir. 1990).

[12] 485 U.S. 224 (1988).

[13] See 15 U.S.C. § 78u-4(b)(4).

[14] Fed. R. Civ. P. 23(c)(1)(C) Advisory Comm. notes 2003; see also Initial Public Offering, 471 F.3d at 39 (analyzing the 2003 amendments to Federal Rule 23).

[15] Initial Public Offering, 471 F.3d at 41.

[16] Oscar Private Equity, 487 F.3d at 262.

[17] Id. at 264.

[18] Id. at 265.

[19] Id.

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[20] Id. at 267.

[21] Luskin, 2008 WL 104273, at *2.

[22] Id. at *5.

[23] Id. at *4.

[24] In re Credit Suisse, 2008 WL 512779, at *6.

[25] See id. at 6 n.11.

[26] Schwab v. Philip Morris USA, Inc., 449 F. Supp. 2d 992, 1098-99 (E.D.N.Y. 2006).

[27] In re Cendant Corp. Sec. Litig., 404 F.3d 173, 195 (3d Cir. 2005).

[28] See, e.g., In re Flag Telecom Holdings, Ltd. Sec. Litig., 245 F.R.D. 147, 172 (S.D.N.Y. 2007

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