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THE NINTH CIRCUIT'S RECENT DECISIONS ON THE PLEADING OF LOSS CAUSATION IN SECURITIES FRAUD CASES

In this article the author analyzes recent securities fraud cases in the Ninth Circuit and finds that their treatment of loss causation demonstrates a need for Supreme Court intervention.

By Lyle Roberts *

Loss causation – the causal connection between a defendant's fraudulent conduct and a plaintiff's economic loss – is a required element of a federal securities fraud claim.[1] A typical securities class action is brought on behalf of investors who contend they purchased a company's stock in reliance on corporate misstatements. The investors allege that they purchased their shares at a price artificially inflated by the misstatements, and then suffered damage when the truth about the misstatements was revealed to the market and the stock price dropped.

The U.S. Supreme Court has explained that the loss causation requirement ensures that a plaintiff may recover losses based on a stock price's decline only to the extent that the loss was caused by a misstatement, rather than by "other intervening causes, such as changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events."[2] Whether and to what extent it is possible to filter out these other intervening causes at the motion to dismiss stage of a securities fraud case, however, is an open question in the lower courts.

Pleading loss causation can be straightforward when a false statement by a company causes its stock's price to rise and then the company makes a corrective disclosure and the price falls. For example, a company says it discovered gold, its stock price goes up $10, then a few months later the company admits it was fool's gold, and its stock price goes down $10. For an investor who bought after the false statement was made and before the corrective disclosure, the causal connection between the false statement and the economic loss associated with the stock price drop should not be difficult to establish. In real life, however, the facts are rarely that simple.

Even assuming that the company operates in an efficient market where its stock price rapidly reflects all material, public information (a concept known as the efficient market hypothesis, which the Supreme Court has expressly adopted in this area of the law),[3] serious

[1] 15 U.S.C. § 78u–4(b)(4); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 338 (2005).

[2] *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 563 U.S. 804, 812-13 (2011) (citing and quoting *Dura*).

[3] *Basic Inc. v. Levinson*, 485 U.S. 224, 246-47 (1988) (establishing presumption of reliance for securities class actions). Lower courts also have applied the efficient market hypothesis when addressing loss causation allegations. *See, e.g., In re KBC Asset Mgmt. N.V.*, 572 F. App'x 356, 360 (6th Cir. 2014) (disclosure of "public information that the market absorbed long before" cannot support loss causation); *Katyle v. Penn Nat'l Gaming, Inc.*, 637 F.3d 462, 473 n.6 (4th Cir. 2011) ("only the first revelation (or series of partial revelations) of facts apprising the market of the entire truth … will affect a

* *LYLE ROBERTS is a partner in the litigation practice of Shearman & Sterling LLP in their Washington, DC office. His e-mail address is lyle.roberts@shearman.com.*

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complications arise as soon as one moves away from the straightforward "fool's gold" fact pattern. What if the information that the company only found fool's gold is contained in a judicial complaint or short seller report, but is never confirmed by the company? What if the information about the fool's gold is publicly available, but must be obtained from the company's government regulator? What if the company's stock price goes down $10 following the corrective disclosure about fool's gold, but then immediately goes up $10 the next day? In the last six months, the U.S. Court of Appeals for the Ninth Circuit has addressed all of those issues, but its answers are creating confusion for both plaintiffs and defendants.

Creating a uniform and consistent pleading standard for loss causation is important. There are over 200 class actions alleging securities fraud or negligent misrepresentations in connection with securities offerings filed in federal court every year.[4] Last year, nearly 40% of these cases were filed in courts located in the Ninth Circuit (79 filings out of 210 total filings).[5] These cases typically settle if plaintiffs are able to survive a motion to dismiss, with an average settlement value over the past four years – excluding outliers – of nearly $30 million.[6] The loss causation pleading requirement is a barrier against meritless suits, preventing securities class actions from being used as an "*in terrorem* device" to force companies into settling claims to "avoid the cost and burden of litigation."[7] Accordingly, if presented with the opportunity, it is time for the Supreme Court to intervene on some of the key questions recently raised by the Ninth Circuit.

WHAT CONSTITUTES AN ADEQUATE CORRECTIVE DISCLOSURE?

Courts have routinely found, applying the common law concept of proximate causation, that an alleged corrective disclosure does not have to reveal that a fraud occurred (*i.e.*, that the misstatement was made with fraudulent intent). Instead, it is sufficient that the "the truth became known" to the market and the stock price declined as a result.[8] In *In re BofI Holding, Inc. Securities Litig.*, 977 F.3d 781 (9th Cir. 2020) ("*BofI Securities*"), however, the Ninth Circuit decided to take on a far more subjective question: whose truth?

The plaintiffs in *BofI Securities* alleged that the defendant bank had made false or misleading statements about its loan underwriting standards, internal controls, and compliance infrastructure. The fraud supposedly was revealed by "a whistleblower lawsuit filed by a former company insider and a series of blog posts offering negative reports about the company's operations."[9] The district court found that neither of these items were "corrective disclosures" because (a) the complaint contained only unsubstantiated allegations

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stock's price"); *In re Omnicom Grp., Inc. Sec. Litig.*, 597 F.3d 501, 512 (2d Cir. 2010) ("negative characterization of already-public information" cannot show loss causation); *In re Merck & Co., Inc. Sec. Litig.*, 432 F.3d 261, 271 (3d Cir. 2005) ("[a]n efficient market for good news is an efficient market for bad news").

[4] *Recent Trends in Securities Class Action Litigation: 2020 Full Year in Review,* NERA Economic Consulting, Jan. 25, 2021 ("NERA Report") at 3.

[5] *Id.* at 3, 5.

[6] *Id.* at 16.

[7] *Meyer v. Greene*, 710 F. 3d 1189, 1196 (11th Cir. 2013) (citing *Dura*, 544 U.S. at 347-48). *See also Hevesi v. Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004) (noting "numerous courts and scholars have warned that settlements in large [securities] class actions can be divorced from the parties' underlying legal positions"); *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001) (discussing the "inordinate or hydraulic pressure on [securities fraud] defendants to settle, avoiding the risk, however small, of potentially ruinous liability"); *West v. Prudential Sec., Inc.*, 282 F.3d 935, 937 (7th Cir. 2002) (discussing circumstances that "lead[] defendants to pay substantial sums even when the plaintiffs have weak positions").

[8] *Dura*, 544 U.S. at 342-343, 347.

[9] *BofI Securities*, 977 F.3d at 786.

that had not been subsequently confirmed and (b) the blog posts were based entirely on existing public information.[10]

On appeal, the Ninth Circuit disagreed with the district court's imposition of "bright-line rules" in its decision. The panel held that the relevant question for loss causation purposes is "whether the market reasonably perceived [the whistleblower's] allegations as true and acted upon them accordingly."[11] No subsequent confirmation of the allegations is needed so long as "the market treats allegations in a lawsuit as sufficiently credible to be acted upon as truth, and the inflation in the stock price attributable to the defendant's misstatements is dissipated as a result."[12] Given that the whistleblower complaint was brought by an insider and the company's stock price dropped significantly after it was filed, the court concluded that this standard was met.

As to the blog posts, the Ninth Circuit held that "[t]o rely on a corrective disclosure that is based on publicly available information, a plaintiff must plead with particularity facts plausibly explaining why the information was not yet reflected in the company's stock price."[13] The panel found that the blog posts "required extensive and tedious research involving the analysis of far-flung bits and pieces of data" and, as result, provided new information to the market.[14] Because they were written by short sellers and expressly disclaimed their own accuracy, however, the panel concluded that "it is not plausible that the market reasonably perceived these posts as revealing the falsity of BofI's prior misstatements, thereby causing the drops in BofI's stock price on the days the posts appeared."[15]

In a strongly worded dissent, Judge Lee disagreed with the panel's reasoning. Judge Lee noted that there had been multiple government investigations of BofI, but "so far, we have not seen any external evidence corroborating [the whistleblower's] allegations."[16] The majority's decision, in Judge Lee's view, would have "the unintended effect of giving the greenlight for securities fraud lawsuits based on unsubstantiated assertions that may turn out to be nothing more than wisps of innuendo and speculation."[17] Nor does it help to say that the allegations in the judicial complaint must be plausible, because "the plausibility standard will likely stave off only lawsuits based on insider accounts that even Mulder and Scully would find unbelievable."[18] In sum, "[b]efore plaintiffs can establish loss causation based on an unsubstantiated whistleblower complaint, another shoe has to drop. It has not yet."[19] As to the blog posts, Judge Lee concluded that he would base the decision "on the grounds that the [blog] posts contain public information only, and that we should not credit anonymous posts on a website notorious for self-interested short-sellers trafficking in rumors for their own pecuniary gain."[20]

The problem that the *BofI Securities* panel grappled with as to the whistleblower complaint is not new. Courts are understandably reluctant to throw out claims on the basis that the "corrective disclosure" does not exactly mirror the alleged misstatement – *i.e.*, gold vs. fool's gold. The concern is that a related disclosure – for example, that the Securities and Exchange Commission is investigating whether the company misled its investors about finding gold – could cause the stock price to go down and, with that decline built into the price, a later disclosure confirming that it was only fool's gold might not cause a further price drop. But saying that the truth can be revealed in different ways is a far cry from saying, as the Ninth Circuit does in *BofI Securities*, that the only issue is whether the market *perceived* that the truth had been revealed. Judge Lee's dissent – as to both the judicial complaint and the blog posts – is more in line with the holdings of other circuit courts, which have found that the "other shoe" does indeed have to drop.

The panel in *BofI Securities* cited a U.S. Court of Appeals for the Sixth Circuit decision – *Norfolk County Retirement System v. Community Health Systems, Inc.*, 877 F.3d 687 (6th Cir. 2017) ("*Norfolk County*") – in support of its "perception" test. The panel appears, however, to have read that decision too broadly. While the Sixth Circuit rejected the defendants' argument for a bright-line rule that a "complaint could not reveal the truth behind their prior alleged misrepresentations because complaints can reveal only allegations rather

[10] *Id*. at 788-89.

[11] *Id.* at 792.

[12] *Id.*

[13] *Id.* at 794.

[14] *Id.* at 797.

[15] *Id.*

[16] *Id.* at 799 (Lee, J. concurring in part and dissenting in part).

[17] *Id.* at 799-800.

[18] *Id.* at 800.

[19] *Id.* at 801.

[20] *Id.*

than truth,"[21] it went on to specifically find that following the filing of the complaint a company officer "promptly admitted the truth of one of the complaint's core allegations."[22] In other words, the company later confirmed that a misstatement had occurred. That approach to the issue is entirely consistent with a pair of U.S. Court of Appeals for the Eleventh Circuit decisions on the same topic, where that court has held that disclosures like judicial complaints and SEC investigations can only be "corrective" if the allegations in those disclosures later turn out to have objective merit.[23] In sum, the real question for purposes of proximate causation is not the market's "perception of the truth" (a topic about which there is no reason to think that a court has any particular expertise), but whether the truth was revealed by allegations that are later found to have been accurate.

Nor does the *BofI Securities* decision hold up much better on the topic of the blog posts. Perhaps feeling constrained by its analysis of the whistleblower complaint, the panel again focused on *who* was making the allegations, rather than whether the allegations actually revealed (directly or indirectly) that any misstatements had occurred. It is not clear why the court's assessment of the "credibility" of the short sellers should matter, if it had turned out that (a) the bloggers actually did provide new information to the market revealing the existence of misstatements and (b) the company's stock price declined in reaction to the posts. Again, Judge Lee's dissent is more in line with the other circuit courts that have addressed the issue: if the blog posts are based entirely on public information, there generally is no reason to believe that they are providing any new information to investors.[24]

WHAT CONSTITUTES PUBLIC INFORMATION?

In securities fraud cases, public information cannot constitute a corrective disclosure because that information already has been incorporated into the company's stock price (under the efficient market hypothesis). The application of that legal principle, however, puts pressure on the definition of "public." If the company has issued a press release stating that it found fool's gold not real gold, the subsequent announcement of a SEC investigation that leads to a stock price decline likely is not a corrective disclosure as to the original misstatement. It is reasonable to assume that the stock price decline is in reaction to the possibility of a SEC action, not the underlying fact that the company did not find gold. But what if the truth has not been that widely dispersed – *i.e.*, if the information about fool's gold is in a third-party disclosure or held by government regulators?

In *Grigsby v. BofI Holding, Inc.*, 979 F.3d 1198 (9th Cir. 2020) (*"Grigsby"*), the plaintiffs alleged that BofI engaged in securities fraud by falsely denying that the company was the subject of a Department of Justice and SEC money laundering investigation.[25] According to the plaintiffs, this denial was revealed to be false when information received from the SEC pursuant to a Freedom of Information Act ("FOIA") request uncovered the existence of an ongoing SEC investigation into the company.

The district court held that information obtained through a FOIA request could not act as a corrective disclosure for purposes of establishing loss causation because the information was "publicly available to an information-hungry market."[26] While the plaintiffs alleged that the SEC had granted (in full or in part) only five other BofI-related FOIA requests during the relevant time period, and there was no reason to believe that any of those requests had revealed the existence of the investigation, the district court concluded that this did not plausibly establish that market participants had not already learned about the investigation.[27]

On appeal, the Ninth Circuit disagreed, finding (arguably contrary to its earlier decision in *BofI Securities*) that the plaintiffs did *not* have to explain why the SEC investigation was not yet reflected in the company's stock price, but rather it was enough for the plaintiffs to plausibly allege that a corrective disclosure revealed that misstatements had occurred. In particular, the panel held "there must be some indication that the relevant information was requested and produced before the information contained in a FOIA response can be considered publicly available for purposes of loss

[21] *Norfolk County*, 877 F. 3d at 696.

[22] *Id.*

[23] *Sapssov v. Health Mgmt. Assoc.*, 608 Fed Appx. to 608 F. App'x (11th Cir. 2015) (judicial complaint); *Meyer v. Greene*, 710 F.3d 1189, 1201 (11th Cir. 2013) (SEC investigation).

[24] *See, e.g., Omnicom Grp.*, 597 F.3d at 512 ("negative characterization of already-public information" cannot show loss causation).

[25] BofI Holding is the same corporate defendant as in *BofI Securities*, but *Grigsby* is a different case, alleging a different class period, and it was heard by a new Ninth Circuit panel.

[26] *Grigsby*, 979 F.3d at 1204.

[27] *Id.*

causation."[28] Moreover, the plaintiffs were not required to disprove that this had taken place. To the extent that it was not clear from the earlier FOIA requests whether the public had learned of the existence of the investigation, the "record does not allow the conclusion that any of the other BofI-related FOIA requests resulted in the disclosure of information about an SEC investigation of BofI."[29]

The key question in *Grigsby* is when is information sufficiently public that, under the efficient market hypothesis, a court can assume it must be reflected in the company's stock price? The Eleventh Circuit, in *Meyer v. Greene*, has applied a bright-line rule that if the sources of the information in the corrective disclosure are public, that is "fatal" to any claim of loss causation.[30] In *Grigsby*, it was undisputed that the source of the information was public (the government via a FOIA request). The panel, however, found that someone must show whether the publicly available information also was known and disseminated.[31] But exactly how does a court measure whether the information has been sufficiently publicized, and do the plaintiffs or the defendants have the pleading burden on this issue? In *BofI Securities*, the panel held that *plaintiffs* who rely on a corrective disclosure that uses publicly available information must plausibly explain why the information was not yet reflected in the company's stock price. In *Grigsby*, the panel held that *defendants* who assert that a corrective disclosure has used publicly available information must plausibly explain why the information was already reflected in the company's stock price. It is hard to reconcile these holdings, other than with an unsatisfactory conclusion that different facts make for different law.

DOES IT MATTER IF THE STOCK PRICE GOES RIGHT BACK UP?

Under the efficient market hypothesis, which the Ninth Circuit applied rigorously in *BofI Securities* and *Grigsby*, if a company trades on an efficient market its stock price rapidly will reflect all material, public information.[32] So then what should a court make of loss causation allegations when a company's stock price drops after a corrective disclosure, but then quickly rebounds. Does that make a difference in assessing whether plaintiffs have adequately pleaded loss causation?

In *Wochos v. Tesla, Inc.*, 985 F. 3d 1180 (9th Cir. 2021) ("*Wochos*") the plaintiffs alleged that Tesla made false and misleading statements about the company's progress in building its production capacity for its mass-market electric vehicle. The district court dismissed the case on the basis that the alleged misstatements were inactionable under the Private Securities Litigation

[28] *Id.* at 1206.

[29] *Id.* at 1207. The *Grigsby* panel also found that a short seller article about BofI did not act as a separate corrective disclosure because the article stated that it was based on public information and the "article's analysis did not require any expertise or specialized skills beyond what a typical market participant would possess." *Id.* at 1208.

[30] *Meyer*, 710 F.3d at 1198**.** The Eleventh Circuit found that while it "might be willing to countenance some lag in the market's processing" of information only available in government records, that did not alter its view that the information was "publicly available" for purposes of assessing loss causation allegations. *Id.* at 1198 n.9. On the other hand, both the Fifth Circuit and the Ninth Circuit have expressed reluctance to extend this concept too far, at least in situations where the public data might require further analysis. *Pub. Emps.' Ret. Sys. of Miss. v. Amedisys, Inc.*, 769 F.3d 313, 323 (5th Cir. 2014) ("it is plausible that . . . the efficient market was not aware of the hidden meaning of the Medicare data that required expert analysis, especially where the data itself is only available to a narrow segment of the public and not the public at large"); *In re Gilead Sec. Litig.*, 536 F.3d 1049, 1058 (9th Cir. 2008) (finding it plausible that there was a three-month delay between the issuance of an FDA warning letter and the alleged stock price drop because it was "not unreasonable that physicians . . . would respond to the Warning Letter" by issuing fewer prescriptions and lowering demand for the drug, "while the public failed to appreciate its significance").

[31] *BofI Securities* and *Grigsby* both appear to adopt a "dissemination" standard for whether information has been incorporated into a company's stock price. *BofI Securities*,

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977 F.3d at 795 (whether information is new to the market must be assessed on a case-by-case basis, including the "effort needed to locate and analyze it"); *Grigsby*, 979 F.3d at 1206 ("there must be some indication that the relevant information was requested and produced before the information contained in a FOIA response can be considered publicly available for purposes of loss causation"). The panels are silent, however, on exactly how lower courts should make this assessment.

[32] *Ninth Circuit Confirms Role of Efficient-Market Theory in Loss Causation*, ABA Practice Points, Dec. 14, 2020 (https://www.americanbar.org/groups/litigation/committees/securities/practice/2020/ninth-circuit-confirms-role-of-efficient-market-theory-in-loss-causation/).

Reform Act's safe harbor for forward-looking statements.[33]

On appeal, the plaintiffs argued that not only did the district court improperly find that the misstatements alleged in the complaint were inactionable, but it also wrongly denied leave to amend the complaint to allege the existence of an additional misstatement. In a lengthy and careful opinion, the Ninth Circuit held that the alleged misstatements in the complaint were either forward-looking and accompanied by meaningful cautionary language, or were otherwise inadequately pleaded as false.[34] As to the issue of leave to amend, however, the panel went on a loss causation tangent.

The plaintiffs argued that in August 2017, Tesla made a statement falsely suggesting that it "had completed the 'machine-that-makes-the-machine' – that is, the automated assembly line – and had started such automated production in July."[35] The Ninth Circuit found that an amendment to the complaint to add this alleged misstatement would be futile because the plaintiffs would be unable to establish loss causation. An October 6, 2017, *Wall Street Journal* article revealed that the cars were still being made by hand. In the immediate aftermath of that article, Tesla's stock price dropped from $356.88 to $342.94. However, the panel noted, "the stock price immediately rebounded, closing at $355.59 on October 10 and trading between $350 and $360 over the next week."[36] The panel found that this "quick and sustained" stock price recovery refuted "the inference that the alleged concealment of this particular fact caused any material drop in the stock price" and "Plaintiffs have thus failed to show that they can adequately plead loss causation."[37]

The question presented by the *Wochos* decision is whether it is appropriate for a court to assume that the stock price rebound means the alleged fraud was immaterial. The U.S. Court of Appeals for the Second Circuit has considered this exact same "rebound defense" and squarely held that a stock price recovery has no effect on the ability of a plaintiff to adequately plead loss causation. *Acticon AG v. China N. E. Petroleum Holdings Ltd.*, 692 F.3d 34 (2d Cir. 2012) ("*Acticon*"). In *Acticon*, the Second Circuit reasoned that losses in securities fraud cases are measured by out-of-pocket damages – *i.e.*, the difference in the price paid for the stock and the actual value of the stock at that time. Accordingly, it is "improper to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud if the stock recovers value for completely unrelated reasons."[38] Whether those reasons are in fact unrelated is something that can only be determined later. At the motion-to-dismiss stage, "the recovery does not negate the inference that [the plaintiff] suffered an economic loss."[39] It is safe to say that there now is a clear circuit split on this issue.[40]

* * *

The Ninth Circuit's recent jurisprudence on loss causation has created both intra-circuit and inter-circuit splits on a number of key issues surrounding the pleading of loss causation. Despite these splits, in *BofI Securities*, *Grigsby*, and *Wochos*, the Ninth Circuit rejected motions seeking reconsideration or *en banc* review of the decisions.

In 2005, the Supreme Court decided *Dura Pharmaceuticals v. Broudo*, where it held that plaintiffs must plead and prove that there was a causal connection between the alleged misrepresentations and the subsequent decline in the stock price. However, the Court did not address what constitutes an adequate corrective disclosure, how to define "public information," or if an immediate stock price recovery makes any difference. In the intervening 15 years, lower courts have come to significantly different conclusions on those issues. The Ninth Circuit's recent loss causation jurisprudence makes clear that it is time for the Supreme Court to finally fill in those gaps and bring uniformity to the lower courts. ■

[33] *Wochos*, 985 F.3d at 1187-88.

[34] *Id.* at 1188-1197.

[35] *Id.* at 1197.

[36] *Id.* at 1198.

[37] *Id.*

[38] *Acticon*, 692 F.3d at 41.

[39] *Id.*

[40] The *Wochos* panel cites an earlier Ninth Circuit decision – *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1064-65 (9th Cir. 2008) – in support of its holding. *Metzler* does note that the corporate defendant's stock price "quickly recovered" after one of the alleged corrective disclosures in that case, but only as part of a broader discussion as to why the plaintiffs' inference that the disclosure revealed a systemic fraud was not plausible. *Id.* at 1065.