Challenging Loss Causation In The 2nd Circ.

Law360, New York (April 18, 2011) -- On April 25, 2011, the U.S. Supreme Court will hear oral argument in Erica P. John Fund Inc. v. Halliburton Co., 131 S. Ct. 856 (2011). Some legal commentators, and even the parties, have said that Halliburton will resolve whether a plaintiff must establish “loss causation” — the element of a securities fraud claim that requires a showing that the alleged fraud caused an economic loss to investors — in order to win class certification.

But that is too broad a characterization. The question presented in Halliburton is only whether plaintiffs in a securities fraud class action must establish loss causation at the class certification stage in order to successfully invoke the fraud-on-the-market presumption of reliance and thereby establish the predominance requirement of Rule 23(b)(3) of the Federal Rules of Civil Procedure. (Brief of Petitioner at i.)

But even if the court were to rule that showing loss causation was not necessary to invoke the fraud-on-the-market doctrine, plaintiffs in securities fraud class actions (at least plaintiffs in the Second Circuit) would still have to establish (and not just plead) loss causation at the class certification stage in order to satisfy certain other requirements of Rule 23, including Rule 23(c)(1)(B), which demands that district courts properly define the scope of a certified class.

This requirement was made crystal clear in the Second Circuit’s decision in In re FLAG Telecom Holdings Ltd. Sec. Litig., 574 F.3d 29, 41 (2d Cir. 2009), where the defendants asserted that “in-and-out investors” (i.e., those investors who sold the company’s shares before the first corrective disclosure) should be excluded from the class definition because, as a matter of law, they could not prove loss causation. See id. at 38.

The Second Circuit agreed with the defendants’ arguments, reversed the district court, and excluded the in-and-out investors from the class definition. See id. at 41. The appellate court held that, even though loss causation is typically a merits issue, it was properly analyzed in the context of class certification, and on interlocutory review under Rule 23(f), because it implicated “the court’s authority to define the class, pursuant to Fed. R. Civ. P. 23(c)(1)(B), and the typicality and adequacy of representation requirements of Rule 23(a).” Id. at 37-38.
Thus, even if the Supreme Court reverses Halliburton, plaintiffs will still likely have to prove loss causation at the class certification stage under certain circumstances and defendants will continue to have an important tool for resisting overbroad classes.

The Law Prior to FLAG

Prior to FLAG, district courts routinely rejected efforts by defendants to narrow the class definition because their arguments raised merits issues that, according to the courts, were not appropriate for consideration on a motion for class certification.

In In re Omnicom Group Inc. Sec. Litig., 2007 U.S. Dist. LEXIS 31963, at *26-27 (S.D.N.Y. Apr. 30, 2007), for example, the defendants asserted that the class period should be narrowed because the alleged corrective disclosure did not specifically mention one of the two frauds alleged by the plaintiffs.

The district court, rejecting this argument, held that “it would be inappropriate to render the determination as to loss causation at this stage of the litigation.” Id. at *27; see also id. at *28 (stating that the court was unwilling “to turn class certification into a partial summary judgment on the merits”).

Similarly, in In re NTL, Inc. Sec. Litig., 2006 U.S. Dist LEXIS 5346, at *51-53 (S.D.N.Y. Feb. 14, 2006), the defendants argued that the class period should end two weeks earlier because the plaintiffs had not alleged a valid corrective disclosure on the later date. There, too, the district court concluded that “this Court need not address the merits of Plaintiff’s individual claim in order to determine the period.” Id. at *52; see also id. at *37 n.15 (stating that “defendants’ opposition to class certification on this ground essentially is a motion to dismiss on loss causation grounds”).

The FLAG Decision

The FLAG decision effectively abrogated this line of authority. In FLAG, the defendants argued that any purchaser of FLAG common stock who sold shares before the end of the class period could not prove loss causation and should be excluded from the certified class.

The plaintiffs — relying on Omnicom and NTL — argued that loss causation is a pure merits issue with no overlap to the requirements of Rule 23 and should not be decided on motion for class certification. The Second Circuit rejected the plaintiffs’ arguments and, for the first time in a securities fraud case, ruled that a court can evaluate loss causation on a motion for class certification. See FLAG, 574 F.3d at 38.

Relying on its 2006 decision in In re Initial Public Offerings Sec. Litig., 471 F.3d 24 (2d Cir. 2006), the Second Circuit emphasized that lower courts have an “obligation” to resolve factual disputes relevant to the Rule 23 requirements and that obligation is “not lessened by overlap between a Rule 23 requirement and a merits issue.” FLAG, 574 F.3d at 38.
The FLAG court then went one step further. For the first time, it held that the standards set forth in IPO applied not only to the requirements of Rule 23(a) and (b), but also to “any of the Rule 23 requirements, including the definition of the class.” Id. Applying this standard, the court ruled that, even though loss causation is typically a merits issue, review of the district court’s analysis concerning in-and-out traders was proper because it implicated “the court’s authority to define the class, pursuant to Fed. R. Civ. P. 23(c)(1)(B), and the typicality and adequacy of representation requirements of Rule 23(a).” Id. at 37-38.

Having determined that it could address a traditional merits issue like loss causation in order to define the class properly, the Second Circuit turned to the specifics of the defendants’ challenge. The plaintiffs had asserted that the in-and-out investors could establish loss causation because the truth had leaked into the market prior to the end of the class period through twenty-two partial corrective disclosures that allegedly caused FLAG’s stock to decline.

The Second Circuit, however, rejected the plaintiffs’ assertion, ruling that the plaintiffs’ alleged partial corrective disclosures had “failed to demonstrate that any of the information that ‘leaked’ into the market prior to February 13, 2002, revealed the truth with respect to the specific misrepresentations alleged.” Id. at 41.

As a result, the court concluded that the plaintiffs had “not put forth sufficient evidence on which the in-and-out traders could establish loss causation, and they must therefore be excluded from the certified class.” Id.

**Potential Uses of the FLAG Decision**

Following FLAG, defendants should routinely assert that the class definition should exclude all investors who sold their shares prior to the first corrective disclosure. See, e.g., In re Sadia SA Sec. Litig., 269 F.R.D. 298, 317-18 (S.D.N.Y. 2010) (citing FLAG and excluding from the class definition all investors who sold their shares prior to the first corrective disclosure); In re Am. Int’l Group Inc. Sec. Litig., 265 F.R.D. 157, 174 n.9 (S.D.N.Y. 2010) (same).

The exclusion of in-and-out investors from the class definition can dramatically reduce a defendant’s potential damages. In fact, in the FLAG case, the plaintiffs stated in their motion for reconsideration that the exclusion of such purported class members from the certified class would reduce claimed damages from $315 million to $14 million.

The significance of the FLAG decision, however, is not limited to excluding in-and-out investors from the class definition. The court’s ruling also provides support for two additional strategies for limiting the size of a class in securities fraud cases.

First, the FLAG decision appears to apply not only to claims under the Securities Exchange Act of 1934, but also to claims under the Securities Act of 1933. See id. at 41. This is a potentially significant development because it seems to provide a new avenue for defendants in cases under Section 11 and Section 12(a)(2) of the Securities Act to challenge the scope of the class and limit potential damages.
Under Sections 11 and 12(a)(2), defendants have an affirmative defense of “negative causation” pursuant to which they can avoid damages for certain investor losses if they can prove that those losses were caused by something other than the alleged material misstatement or omission in the offering materials. In FLAG, the Second Circuit held that any decline in the price of the company’s securities prior to the first corrective disclosure was not caused by the alleged fraud and, therefore, negative causation was established as a matter of law up to that point. See id.

Second, the FLAG decision emphasizes that, just like challenges to class certification based on the requirements of Rule 23(a) or (b), issues regarding the proper scope of a proposed class under Rule 23(c) should be addressed during the class certification process even when they overlap with merits issues. See id. at 37-38.

The heightened focus on Rule 23(c) in the class certification process provides defendants with an additional avenue to challenge the merits of the plaintiffs’ claim. See id. Thus, whenever a plaintiff attempts to include a group of investors in the class definition who cannot establish an element of the claim — because, for example, they cannot trace their shares to a particular share offering, cannot establish jurisdiction, or cannot establish standing — the defendants should attempt to exclude these investors from the class definition during the class certification process.

Although it has received relatively little attention from the securities bar, the FLAG ruling provides important mechanisms by which defendants can limit the size of classes in securities fraud cases, and these mechanisms may well survive the Supreme Court’s decision in Halliburton. These strategies can significantly limit the ability of plaintiffs to press for unreasonable settlements based on inflated estimates of potential damages.

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