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REPORT

Jurisdiction and Procedure

Efficient Markets, Effective Adjudication: Loss Causation and Class Certification in Financial Fraud and Subprime Litigation

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Arguments based on the absence of "loss causation" are a powerful weapon in the legal arsenal of a securities litigation defense lawyer. As the Supreme Court explained four years ago in *Dura Pharmaceuticals, Inc. v. Broudo*, the federal securities laws are not intended "to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause."[1] In other words, a plaintiff has to prove not only that a defendant committed fraud, and not only that the plaintiff lost money, but that the former led directly to the latter. In complex securities markets, this often may be an extremely difficult task. If the issue ripens for adjudication at an early stage, the litigation can be ended well before steep legal fees and expenses are incurred by the defendant. Other critical factual issues arising in a securities fraud action – whether a representation was false or misleading; whether information misrepresented or omitted was material; whether the defendant acted intentionally – ordinarily must await the completion of discovery before they can be resolved. Loss causation, however – focused on the operation of public markets and based, for the most part, on public information that is equally available to both sides – is capable of resolution much earlier in the litigation. If defense counsel can persuade the court, at a preliminary stage, that no damages are fairly traceable to the challenged conduct, the client can be spared extensive costs and disruption to its business.

The first time the issue may arise is in the context of a motion to dismiss. *Dura* itself arose in that posture, and held, among other things, that a plaintiff is required to plead the causal connection by which it claims it was injured, and to do so with sufficient specificity to put the defendant on notice of what it intends to prove later in the case.[2] It is insufficient for a plaintiff to plead that it purchased shares at an inflated price, even if share

[1] 544 U.S. 336, 345 (2005).

[2] *Id.* at 347.

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prices subsequently declined.[3] The plaintiff must show that the share price declined *as a result* of the truth making its way into the market.[4] Following *Dura*, courts now require that plaintiffs plead and prove a ''corrective disclosure'' or some revelation to the market of new information by which the ''truth'' became known, proximately causing negative share-price movements.[5]

A recent district court decision from the Central District of California illustrates the appropriate analysis at the motion to dismiss stage, in the context of subprime litigation. In *In re Downey Securities Litigation*,[6] the plaintiffs alleged that Downey Financial Corporation made misrepresentations concerning the extent of its subprime loan portfolio, the ''exotic'' and ''toxic'' nature of certain of its mortgages, and its practices for verifying borrower creditworthiness and property value, and that the defendants misrepresented the company's financial condition through violations of Generally Accepted Accounting Principles and other misstatements.[7] With respect to the element of loss causation, the plaintiffs alleged that when Downey announced a new ''borrower retention program'' involving troubled debt restructurings (and a concomitant $99 million writedown in mortgage assets), Downey's share price declined.[8] The court held that this allegation was insufficient, because no fraud was revealed to the market – at most, the allegations suggested that ''the market learned of and reacted to Downey's 'poor financial health' rather than any alleged fraud.''[9] The court, therefore, dismissed the complaint.

If the plaintiff can survive a motion to dismiss, it nevertheless must be able to prove the element of loss causation at some later stage. A plaintiff will typically attempt to do so through an ''event study'' showing that the issuer's stock reacted positively to some allegedly misleading news and negatively when a corrective disclosure revealed the truth to the public. Under the usual methodology, the expert will calculate, for each important date in the case, an expected ''return'' for the stock based on broader market performance (often focusing on a major index and/or an industry group to account for industry-specific market movements), and, if the stock's actual behavior differs from its expected behavior, the return is deemed ''abnormal'' and attributed to any ''company-specific'' information revealed to the market on that date. Where multiple items of company-specific information are revealed on the same day, the task becomes more difficult. In a complex case, with many competing pieces of news (''confounding'' information), the task is a bit like determining the cause of a wave breaking on shore, which has started many miles out to sea. Share price fluctuations have fewer moving parts than an ocean, but many months or years may have passed between the event that starts the ripple (the misleading statement) and the wave crashing on the beach (the corrective disclosure). Performing a reliable study is difficult, but, conclusions can often be reached (by experts for either side) with some degree of certainty.

But what if the wave, traveling from well beyond the proverbial horizon, encounters a far more significant disturbance before it reaches land? Or, what if some natural disaster strikes the beach rendering it virtually impossible to discern what, if any, effects are attributable to the initial ripple rather than the much larger event?

That, in effect, is the task in securities litigation arising in the context of the subprime mortgage crisis. In many cases, issuers' stocks have been in freefall for two years or more. Bank profits have evaporated. Writedowns have come at a breathtaking pace. Major institutions have failed. Investors are bombarded with new pieces of negative information with numbing frequency. Worse yet, nonperforming loans have been so widespread as to inflict significant damage on the economy at large. Broader markets have tumbled as a result, making it difficult or impossible to separate bad news about specific financial institutions from bad news about the financial sector from bad news about the aggregate economy. When securities litigation occurs against this backdrop, proof of loss causation—pinning a day's stock drop on a specific piece of news—may be hopeless.

Litigation related to the meltdown has been historic in its proportions. Navigant Consulting released a study in March 2009 observing that 576 subprime mortgage related civil cases were filed in 2008, representing nearly a 100 percent increase over 2007 filings.[10] A plurality of the 2008 filings – 38 percent – are securities cases.[11] Of that fraction, a large percentage are securities fraud class actions.[12] In the vast majority of those cases that involve publicly traded securities, plaintiffs will need to persuade the courts to apply the ''fraud-on-the-market'' presumption of *Basic v. Levinson*,[13] *i.e.*, the presumption that, while individual plaintiffs may not have been directly privy to any misrepresentations, the information would nevertheless have been effectively conveyed to all investors through securities pricing mechanisms. In subprime litigation, this may be where the ripple meets the tidal wave.

In 2007, 195 subprime-related putative class actions were filed. Only ten percent of those putative classes have been certified. In 2008, 339 putative class actions involving this subject matter were filed. Only two

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[3] *Id.* at 342.

[4] *Id.* at 342-43.

[5] *See, e.g., In re Williams Sec. Litig.*, __ F.3d. __, 2009 WL 388048, at *11 (10th Cir. Feb. 18, 2009) (''Even if the truth has made its way into the marketplace, *Dura* requires that a [plaintiff] show that it was this revelation that caused the loss and not one of the 'tangle of factors' that affect price.''); *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 270 (5th Cir. 2007) (requiring plaintiffs to show ''proof of a corrective disclosure's significant contribution to a price decline''); *Tricont'l Indus. v. PricewaterhouseCoopers LLC*, 475 F.3d 824, 843 (7th Cir. 2007) (requiring plaintiffs to plead and prove ''a material misrepresentation which caused [the plaintiff] to suffer a loss when that material misrepresentation 'became generally known' ''); *Garber v. Legg Mason, Inc.*, 537 F. Supp.2d 597, 617 (S.D.N.Y. 2008) (finding no loss causation because announcements alleged as ''corrective disclosures'' did not reveal the truth).

[6] 2009 WL 736802 (C.D. Cal. Mar. 18, 2009).

[7] *Id.* at *3.

[8] *Id.* at *15.

[9] *Id.*

[10] Jeff Nielsen, *2008: Seeking Relief*, at 2 (Navigant 2008) (''Navigant Report'').

[11] *Id.*

[12] *Id.*

[13] 485 U.S. 224 (1988).

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classes have been certified from that group.[14] Thus, courts have just begun to address the problem.

A plaintiff's motion for class certification is, absent a clear defect in the pleadings, generally the district court's first occasion to dig into the issue of whether *Basic* applies and reliance on the alleged misstatements and/or omissions may be presumed, obviating the need for individual reliance determinations and, if the other elements of Rule 23 are met, enabling investors to proceed as a class. This inquiry can include at least three subsidiary determinations: (1) whether the trading market for the securities in question was efficient as to information; (2) whether the alleged misrepresentations were material; and, perhaps, (3) whether the alleged misrepresentation caused legally significant movements in share price – *i.e.*, the element of loss causation. In a typical case, issue 3, loss causation, is far more challenging for plaintiffs than issues 1 and 2.

In recent years, courts have shown increased willingness to examine these issues thoroughly at the class certification stage. Recent decisions hold that a plaintiff must establish the elements of Rule 23 by a preponderance of the evidence,[15] that the district court must resolve disputed issues of fact,[16] must weigh competing expert testimony,[17] and cannot avoid issues simply because they overlap with the merits.[18] Full evidentiary hearings are becoming more common.[19]

Thus, whether and to what extent a court will address the question of loss causation on a motion for class certification has a profound impact on the outcome of the litigation. Federal courts have split three ways on the issue:

1. **Plaintiff's Burden to Prove Loss Causation.** In the Fifth Circuit, a plaintiff now bears the burden on a motion for class certification of proving, by a preponderance of the evidence, the element of loss causation. Without such proof, that circuit now holds that the ''fraud on the market'' presumption does not apply and no class may be certified.

2. **Defendant May Prove Absence of Loss Causation.** In the Second Circuit, a plaintiff need not show loss causation in order to prevail on a motion for class certification. However, the court recently clarified that a defendant may, at this stage, present a rebuttal case on loss causation and prevent class certification if it can show the absence of this element.

3. **Loss Causation Not Relevant to Class Certification.** Although not yet addressed at the circuit court level, two district courts in the First Circuit have recently declined to follow either of the above two approaches. These courts have held that loss causation is not an issue to be determined at the class certification stage and must be reserved for summary judgment or trial.

We explain this precedent below, beginning with the Fifth Circuit's thoughtful analysis in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*[20] This case is of particular interest in the subprime context because it involved the last great ''tidal wave'' of collapsing share prices – the bursting bubble of internet and telecommunications stocks. It is interesting to consider to what extent those circumstances may have influenced the majority to adopt a particularly stringent approach to loss causation and class certification.

The Oscar Case: A Narrow View of Market Efficiency and Concern for the in Terrorem Effect of Certification In *Oscar*, the Fifth Circuit cemented what is, so far, the most conservative approach among the federal courts to certification of investor classes. In that case, the court reviewed an order certifying a class of all investors who purchased, during a ten month period in 2001 and 2002, the common stock of Allegiance Telecom, a seller of various internet and telephone services.[21] Allegiance made a series of announcements during that time concerning its ''line-installation count,'' an important measure of the demand for its services and the company's capacity to provide them.[22] The company's stock was ''plunging'' throughout the class period.[23] As the Fifth Circuit observed, this was also true of the rest of the telecom industry during 2001.[24] Allegiance's share price did, however, perk up around the time of each of the alleged misstatements – quarterly announcements containing a host of other potentially important facts in addition to line-count information – before continuing its march downward.[25] In total, Allegiance lost nearly 90 percent of its value during 2001.[26] On the last day of the class period, Allegiance restated its line-count downward by about ten percent.[27] It also announced that it had missed analysts' quarterly earnings per share and EBITDA expectations and that the company was perilously close to breaching key covenants with lenders.[28] On the next day of trading, the company's share price fell from $3.70 (it had been $14.90 on the first day of the class period) down to $2.65, a 28 percent one-day decline.[29] Within 90 days thereafter, Allegiance defaulted on certain credit lines and filed for bankruptcy.[30]

The defendants argued to the district court that, in light of the storm of negative information to emerge on the final day of the class period, it would be impossible to assume, for purposes of class certification, that the market operated, with respect to the line-count information, in the way assumed by *Basic* – *i.e.*, that inves-

[14] Navigant Report at 5.

[15] *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.*, 596 F.3d 196, 202 (2d Cir. 2008).

[16] *See Miles v. Merrill Lynch (In re Initial Pub. Offerings Sec. Litig.*), 471 F.3d 24, 41 (2d Cir. 2006) (''*In re IPO*'').

[17] *Id.* at 41-42.

[18] *Id.* at 34-35, 42.

[19] *See, e.g., UCFW Local 236 v. Eli Lilly & Co.*, Nos. 04-MD-1596 2008 WL 4097408, at *28 (E.D.N.Y. Sept. 5, 2008) (''On March 28-31 and April 1-2 of 2008 an extensive evidentiary hearing was conducted to comply with the certification standards set by the Court of Appeals for the Second Circuit.'' (citing *In re IPO*)); *In re Credit Suisse First Boston Corp. Analyst Sec. Litig.*, 250 F.R.D. 137, 140 (S.D.N.Y. 2008) (''As these issues are mixed questions of law and fact, a hearing was held on the Rule 23(b) issue of predominance in order to make a 'definitive assessment . . . notwithstanding . . . overlap with merits issues.' '' (quoting *In re IPO*) (citations omitted, alterations in *Credit Suisse*)).

[20] 487 F.3d 261 (5th Cir. 2007).

[21] *Id.* at 262.

[22] *Id.* at 263.

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

tors effectively relied on it because the information had a legally significant impact on share price. The district court reasoned that this argument went to loss causation, which, it held, was *not* at issue at the class certification stage.[31]

The Fifth Circuit reversed, holding that it is a plaintiff's burden to demonstrate loss causation before an investor class may be certified:

> We now require more than proof of a material misstatement; we require proof that the misstatement *actually moved* the market. . . . Essentially, we require plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption.[32]

The court explained that ''[t]he assumption that every material misrepresentation will move a stock in an efficient market is unfounded'' and that proof of loss causation is actually necessary in order to show the existence of the ''semi-strong'' form of efficient market on which the *Basic* presumption is premised[33]:

- The absence of loss causation may, for example, mean that the market is not efficient as to the *kind* of information (like line-count information) allegedly misrepresented – even if the securities market in which the shares trade is, in other respects, efficient.
- Alternatively, lack of a proximate market reaction to a corrective disclosure may mean that that the market is actually *strong-form* efficient, such that any inflation resulting from misrepresentations would have been dissipated by insider trading.

Under either scenario, the court reasoned, the *Basic* presumption is inappropriate.[34]

The majority also engaged in a lengthy and unusually candid analysis of the practical implications of its holding. In one striking passage, the court explained that it could no longer ''ignore the *in terrorem* power of certification, continuing to abide by the practice of withholding until 'trial' a merit inquiry central to the certification decision.''[35]

The word ''trial'' was given in quotes, no doubt, because only infrequently will plaintiffs actually have to prove to the fact trier by a preponderance of evidence that they were damaged as they have claimed in the complaint. By the same token, once a class is certified, and particularly if defendants do not prevail on summary judgment, even defendants with very strong defenses on the merits face great pressure to accede to a settlement that is, in most cases, orders of magnitude smaller than the damages to which the plaintiffs claim they are entitled, but which is nevertheless quite large. The Fifth Circuit addressed that issue, explaining that such a scenario threatens defendants' right to due process in civil actions:

> The power of the fraud-on-the-market doctrine is on display here. With proof that these securities were being traded in an efficient market, the district court effectively concluded that if plaintiffs can establish at trial that defendants acted with the requisite intent in counting its installations then defendant would be liable for millions of dollars in paper losses on the day following the fourth-quarter filing date, less the amount the defendant may be able to persuade a jury was caused by other circumstances – whether the purchaser held on and later sold at a higher price or rode the stock down to bankruptcy. In short, the efficient market doctrine facilitates an extraordinary aggregation of claims.
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> [A] district court's certification order often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that precedes it. . . . That there are important due process concerns of both plaintiffs and defendants inherent in the certification decision, cannot be gainsaid.[36]

Finally, the court reasoned, there is little need to allow plaintiffs discovery on this question because ''proof'' of loss causation ''is drawn from public data and public filings'' – ''it is largely an empirical judgment that can be made then as well as later in the litigation.''[37] After an exacting scrutiny of the evidence offered by both sides, the court held that the plaintiffs had failed to trigger the fraud-on-the-market presumption of reliance, and it vacated the order of class certification.

The Fifth Circuit is certainly correct in its assessment of the *in terrorem* effect of class certification. It is equally certain, however, that, as a *ratio decidendi*, the court's decision to address this effect reveals a policy preference for guarding against unfair leverage. As explained below, other courts have been express in not sharing that inclination.

The Salomon Analyst Case: More Solicitude for Investor Plaintiffs In *In re Salomon Analyst Metromedia Litigation*, the Second Circuit was faced with deciding whether, in Rule 10b-5 cases against analysts of publicly traded securities, proof is required before a class may be certified that the alleged misrepresentation actually ''moved the market.''[38] The court held that such proof is not required.

First, the court explained that when the *Basic* court spoke to ''material'' misstatements, it did not mean to require a showing of a material effect ''on the market price.''[39] Rather, the plaintiff must simply show that ''the reasonable investor'' would have viewed the misinformation as ''having significantly altered the total mix of information,'' proof of which might take many forms.[40] In clear contrast to the Fifth Circuit's reasoning in *Oscar*, the Second Circuit explained that this less exacting burden is required by *Basic* in order to meet the objective of *enabling* plaintiffs to proceed with otherwise unfeasible cases and to allocate the risk of mistaken adjudication onto the defendant:

> In a pivotal passage, the Court stated that the presumption was justified not by scientific certainty, but by consider-

[31] *Id*. at 266.
[32] *Id*. at 265.
[33] The three forms of the efficient-capital-markets hypothesis differ on what type of information is reflected in prices: ''the weak form of the hypothesis holds that past price movements are incorporated in prices; the semi-strong form suggests that publicly-available information is reflected in prices; and the strong form posits that all information from whatever source is fully incorporated in prices.'' Daniel R. Fischel, *Program Trading, Volatility, Portfolio Insurance, & the Role of Specialists & Market Makers*, 74 Cornell L. Rev. 907, 910-911 (1989).
[34] *Oscar*, 487 F.3d at 269-70.
[35] *Id*. at 267.
[36] *Id*. (internal quotation marks omitted).
[37] *Id*.
[38] 544 F.3d 474, 476 (2d Cir. 2008).
[39] *Id*. at 482.
[40] *Id*. at 485.

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ations of fairness, probability, judicial economy, and common sense.

> . . . [T]he presumption is appropriate in the fraud-on-the-market situation due to the extreme difficulty in demonstrating transaction causation, *i.e.*, reliance. To saddle a plaintiff with proving the generally indeterminable fact of what would have happened but for the omission or the misrepresentations that skewed the market value of stock would reduce the protection against fraud afforded by Section 10(b). The reliance presumption reallocates the risk of mistaken adjudications, resolving questions of doubt in favor of the investors that section 10(b) seeks to protect.
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> Thus, plaintiffs do not bear the burden of showing an impact on price. The point of *Basic* is that an effect on market price is *presumed* based on the materiality of the information and a well-developed market's ability to readily incorporate that information into the price of securities.[41]

Nevertheless, the court held, it is proper and consistent with these principles to permit the defendant ''to rebut the presumption, prior to class certification, by showing . . . the absence of a price impact.''[42] Defendants may do so, for example, by showing ''that the market price was not affected by the alleged misstatements, or [that] other statements in the 'sea of voices' of market commentary were responsible for price discrepancies.''[43]

Thus, in the Second Circuit, the burden as to loss causation is the opposite of the allocation in the Fifth Circuit.[44] Nevertheless, these opposing views do not reflect all possible resolutions of the issue.

District of Massachusetts: Loss Causation is for Summary Judgment or Trial In *In re Credit Suisse-AOL Securities Litigation*, a trial court in the District of Massachusetts held that rebuttal of the fraud-on-the-market presumption must wait for ''summary judgment or trial.''[45] Like *Salomon Analyst*, the *Credit Suisse-AOL* case involved statements by analysts rather than issuers: the plaintiffs alleged that Credit Suisse analysts had issued misleading reports touting the securities of AOL Time Warner, Inc.[46] The defendants argued that, due to the ''qualitative difference'' between statements by issuers and statements by analysts, ''class certification and the application of the *Basic* framework should be conditioned on an additional showing that the analyst reports at issue impacted the market price of AOL.''[47] The court held that any such qualitative difference has no bearing on the predominance inquiry under Rule 23:

> [T]he Court sees no reason to cram an additional requirement into the predominance inquiry that is unrelated to whether ''questions of law or fact common to members of the class predominate over any questions affecting only individual members.'' It is undoubtedly true that statements made by analysts are qualitatively different than those made by issuers of stock. It does not follow, however, that analyst cases are less amenable to class treatment. That loss causation may be more difficult to prove in analyst cases simply has no bearing whatsoever on the appropriateness of class action treatment.
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> The *commonality* of the ultimate reliance inquiry turns on whether the market for the security is efficient, not on the materiality or market impact of defendants' particular statements. Once the presumption attaches, all other questions of loss causation are common to the class. Given that AOL traded on an efficient market, the class' entire claim will rise and fall on the same questions.[48]

The court concluded that the defendants' ''argument regarding market impact, while certainly not insubstantial, do not address the purposes of Rule 23.''[49]

Next, in *In re Boston Scientific Corp. Securities Litigation*, another trial court in the same district extended the holding of *Credit Suisse-AOL* to apply in 10b-5 cases against securities issuers.[50] Plaintiffs in that case alleged that Boston Scientific Corporation concealed material information and made misleading statements about problems with one of its medical device products.[51] During the class period, Boston Scientific allegedly made a series of partial disclosures about the issue, the import of which, it was alleged, did not become apparent until the end of the class period, when the company announced a widespread recall.[52] Following the recall announcement, the company's share price declined by 14.3 percent over three days.[53] The defendants opposed the plaintiff's motion for class certification on the grounds that the plaintiff could not show that the alleged misstatement or corrective disclosure had a statistically significant impact on the stock's price.[54] The court held, however, that this contention did ''not bear on Rule 23(b)(3)'s requirement that questions of law or fact common to class members predominate.''[55]

The court began by explaining the holdings of the Fifth Circuit in *Oscar* and the Second Circuit in *Salomon Analyst*, on which the defendants had relied heavily.[56] It observed, however, that, with respect to ''the necessary degree of inquiry at the class certification stage,'' the ''Second and Fifth circuits are around the more rigorous end of th[e] spectrum.''[57] It therefore declined to follow them.[58] Instead, the court explained, in the First Circuit, a plaintiff seeking class certification ''need only present 'basic facts' that the fraud-on-the-market presumption could be invoked, while the theory's *actual* applicability should be resolved on summary judgment or trial.''[59] Thus, while the defendants had ''raised colorable arguments'' regarding the plaintiff's

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[41] *Id.* at 483 (citations, internal quotation marks, and alterations omitted).

[42] *Id.* at 484.

[43] *Id.* at 485.

[44] *See also In re The Mills Corp. Sec. Litig.*, 1:06-cv00077, April 16, 2009 Memorandum Opinion at 14 (Doc. # 460) (''[R]equiring a factual showing of loss causation at the class certification stage would be – to borrow a cliché – putting the cart before the horse.'').

[45] 253 F.R.D. 17, 30 & n.15 (D. Mass. 2008).

[46] *Id.* at 19.

[47] *Id.* at 28.

[48] *Id.* at 29 (citations omitted).

[49] *Id.* at 30.

[50] 2009 WL 723490 (D. Mass. Mar. 10, 2009).

[51] *Id.* at *1.

[52] *Id.* at *2-3.

[53] *Id.* at *3.

[54] *Id.* at *7. The defendants argued that the 14% drop following the announcement was based on the company's further announcement that it expected disruption in its ability to satisfy international demand and planned to postpone its quarterly earnings announcement, which disclosures, they claimed, were unrelated to the allegedly concealed facts about manufacturing defects. *Id.* at *9.

[55] *Id.* at *8 (internal quotation marks omitted).

[56] *Id.* at *9-10.

[57] *Id.* at *10 (internal quotation marks omitted).

[58] *Id.*

[59] *Id.* (internal quotation marks omitted).

ability to prove loss causation, those issues are not ripe for resolution at the class certification stage, whether by way of proof by the plaintiff or rebuttal by the defendant; instead, ''those issues are more properly addressed on summary judgment or at trial.''[60]

* * *

Obviously decisions like *Boston Scientific* make it more difficult in some districts for a defendant to present a valid loss causation defense at an early stage. Yet that may also be a mixed blessing for plaintiffs – after all, the issue may loom very large at the summary judgment stage. If the court has not addressed the issue at all, a plaintiff whose case has serious loss causation issues may find itself in a diminished negotiating position for settlement purposes until summary judgment can be decided. With fact and expert discovery completed, courts often are less reluctant to subject a plaintiff's loss causation assertions to exacting scrutiny at the summary judgment stage.

The Tenth Circuit's decision in *In re Williams Securities Litigation-WCG Subclass*,[61] another case concerning a telecommunications company's decline and demise in the early part of this decade, is illustrative of the summary judgment process. In that case, the appeals court affirmed a district court's decision to disregard two separate expert opinions on *Daubert* grounds because, among other reasons, they did not sufficiently identify and isolate the effects of an alleged corrective disclosure and ''leakage'' of corrective information into the market to comport with *Dura*.[62] Plaintiffs alleged that the defendants, in effect, misrepresented the financial health of the issuer, WCG, when they announced at the start of the class period that WCG would be spun off from its parent in order to fuel growth and improve the issuer's access to capital. In fact, the plaintiffs alleged, the reason for the spinoff was WCG's poor financial health.[63] Throughout the class period, WCG's stock price declined – as did prices in much of the rest of the industry.[64] At the end of the class period, WCG made two negative announcements concerning its ability to comply with loan agreements, each of which announcements precipitated further drops in the stock price.[65]

The plaintiffs and their expert argued that the period-long decline was caused by the gradual public realization of the true condition of the company, and that the loan-related announcements at the end of the period were further corrective disclosures – a materialization of a risk concealed by the spin-off announcement.[66] The Tenth Circuit, however, held, *inter alia*, that (1) while loss causation due to ''leakage'' of the truth is a potentially viable theory, the plaintiffs' expert had failed ''to describe how the market was alerted to the fraud,''[67] and (2) the disclosures at the end of this period did not sufficiently ''relate back to the misrepresentation and not to some other negative information about the company.''[68] In other words, the court assumed for purposes of its analysis that the defendants had made statements giving the misleading impression that WCG's finances were strong and that its stock price declined as the market learned that the company was not strong, as well as the specifics of its weakness. The court even seemed to accept that the price declined *as a result* of the market's realization that WCG was financially weak, contrary to the defendants' alleged misrepresentations. Yet the court found – as a matter of law – that the connection between the specific alleged misrepresentations and the stock price drop was insufficiently proximate to survive summary judgment. The Tenth Circuit found holes in the plaintiff's theory that were too great for its expert to traverse. Decisions like *Williams* should give pause to any securities plaintiff needing to establish loss causation in a complex case.

Conclusion While the courts in the First Circuit are certainly correct that ''loss causation'' is not a separate element of a plaintiff's motion under Rule 23, it would be a misunderstanding of the fraud-on-the-market presumption to conclude that the issue is not relevant to class certification.

It is uncontroversial that reliance is an element of a Rule 10b-5 claim and that if individual proof is required there can be no class action. *Basic* explains that, in a traditional face-to-face transaction, ''the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor.''[69] But in a modern securities market, it is not presumed that an ordinary investor knows or should know all information about a given investment. Instead, the ''market is interposed between seller and buyer and, ideally, transmits information to the investor in the form of a market price.''[70] Under these conditions, ''the market is performing a substantial part of the valuation process'' and informs the investor that ''given all the information available to it, the value of the stock is worth the market price.''[71] Is it not fair, before concluding that individual reliance need not be proven, to require plaintiffs to show that this is actually happening in a given case?

Plaintiffs' lawyers will respond that *Basic* assumes that ''the market price of shares traded on well-developed markets reflects *all* publicly available information.''[72] But *Basic* also emphasized it did ''not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price.''[73] As common sense would suggest, ''the market price of a security will not be uniformly efficient as to all types of information.''[74] There is no doubt that the plaintiff bears the burden of demonstrating market efficiency.[75] There is, therefore, no unfairness or inconsistency with *Basic* in requiring a plaintiff, before he may dispense, for all practical purposes, with the element of reliance, to show that the market is efficient in the way necessary to act as a substitute for direct reliance on the information it claims was misrepresented. The *Basic* Court explained that its

[60] *Id*. at *11.
[61] __ F.3d __, 2009 WL 388048 (10th Cir. Feb. 18, 2009).
[62] *Id*. at *7-11.
[63] *Id*. at *1-2.
[64] *Id*. at *2.
[65] *Id*.
[66] *Id*. at *2-3.
[67] *Id*. at *6.
[68] *Id*. at *8.

[69] 485 U.S. at 244.
[70] *Id*. at 244 (internal quotation marks omitted).
[71] *Id*. (internal quotation marks omitted).
[72] *Id*. at 246 (emphasis added).
[73] *Id*. at 249 n.28.
[74] Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud on the Market Theory*, 42 Stan. L. Rev. 1059, 1083 (1990).
[75] *Basic*, 485 U.S. at 248 n.27; *Boston Scientific*, 2009 WL 723490, at *10; *Credit Suisse-AOL*, 253 F.R.D. at 31.

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concern was that a plaintiff not be saddled with the ''unnecessarily unrealistic evidentiary burden'' of showing ''a speculative state of facts, *i.e.*, how he would have acted'' if it had known the truth.[76] The rule in *Oscar* is respectful of that concern and simply advances in time, for the purpose of fairness, a legal inquiry that will usually require little to no discovery of relevant facts.

In conclusion, particularly amidst the subprime meltdown, it cannot be assumed that any single piece of misleading information or negative corrective disclosure moved efficiently through the market and reached investors in the form of a market price. There is far too much disturbance to make that assumption based on ''common sense and probability,'' as stated in *Basic*.[77] Plaintiffs in these cases are claiming huge losses resulting from cascading share prices. Courts should not lightly bestow the power of class treatment on plaintiffs who did not rely on a claimed misrepresentation and cannot show that the omitted or misrepresented facts impacted the price of their investments. The same considerations of fairness that motivated *Basic* more than twenty years ago should caution courts against extending it beyond its logical and equitable underpinnings.

[76] *Basic*, 485 U.S. at 245.

[77] *Id*. at 247.