The Second Circuit Rejects Loss Causation Based on Innuendo and Rhetoric

By Scott B. Schreiber and Robert A. Schwartz

The past year has given rise to a number of new appellate decisions concerning the "loss causation" element of a claim under Rule 10b-5. One of the most interesting of these is the decision of the U.S. Court of Appeals for the Second Circuit in *In re Omnicom Group, Inc. Securities Litigation*, 597 F.3d 501 (2d Cir. 2010), in which the court affirmed summary judgment in favor of defendants on fraud claims based on a transaction in which the issuer, Omnicom, moved off of its books certain investments in Internet companies, *id*. at 508–9. The *Omnicom* case has been well summarized previously, *see*, *e.g.*, Peter Wald & Jeff Hammel, *The Second Circuit Opines on Loss Causation in Omnicom*, Securities Docket (March 30, 2010), but one aspect of the decision deserves further discussion—the court's holding that the alleged fraud did not proximately cause losses that were triggered by negative news coverage of related facts, *Omnicom*, 597 F.3d at 512–14. This is a recurring fact pattern. In *Omnicom*, the Second Circuit concluded that the negative coverage simply characterized and spread opinions about earlier-released information. *Id*. at 512. Conceptually, however, negative "spin" and loss alleged to be caused thereby is no more substantial even if released near in time to new "hard facts."

The Seneca "Scandal"

In the year 2000, certain of Omnicom's investments in Internet companies began to perform poorly. With the concurrence of its outside auditor, however, Omnicom decided not to write down their asset value. In the first quarter of 2001, the company entered into an agreement with a private equity investment firm, Pegasus Partners II, L.P., by which Omnicom sold these investments to a newly established joint venture, called Seneca, owned together by Pegasus and Omnicom. The Seneca transaction was announced in a press release, and it was disclosed at the same time that Omnicom would incur no resulting gain or loss from the transaction. The plaintiffs in *Omnicom* alleged that this accounting was fraudulent in a number of respects. *Id*. at 504, 508. Indeed, several news articles at or near the time of the transaction expressed the view that the deal was nothing more than an attempt to move deteriorating investments off of Omnicom's books. The market price of Omnicom's stock did not react to any of this news. *Id*. at 505.

More than a year later, on June 5, 2002, Omnicom filed a Form 8-K to disclose that one of its directors—audit committee chair Robert Callander—had resigned. The plaintiffs in *Ominicom* alleged that Callander resigned over accounting malfeasance in connection with the Seneca transaction. *Id*. at 505, 514. After the 8-K was filed, rumors to that effect began to circulate in the market. On June 6, 2002, reports emerged that *The Wall Street Journal* was preparing to publish a negative story about accounting issues at Omnicom.

A series of reports emerged in the interim. These included (a) a June 7 report by UBS Warburg that the "director who headed the audit committee has given fuel to concerns with accounting irregularity"; (b) a June 10 report in *The Wall Street Journal* that Callander had "quit the board after expressing concerns about the creation of an entity that houses Omnicom's Internet assets"; and (c) a June 11 story in *Financial Times* describing Omnicom investors' "post-Enron concerns about disclosure." *Id*. at 505–6 (internal quotation marks omitted). On June 12, 2002, the rumored article finally appeared in *The Wall Street Journal*, stating, among other things, that Callander "had resigned amid questions about how the company handled a series of soured Internet investments," had "questioned whether something wasn't being disclosed to the board" in this regard, and had "voiced doubts about Seneca's purpose for months." *Id*. at 506 (internal quotation marks omitted). Omnicom's general counsel was quoted in the same article stating that he, the general counsel, had in fact mistakenly told Callander that the Seneca transaction had not been approved by the board. *Id*. The article made reference to the collapse of Enron, still a recent event, and quoted two accounting professors who were critical of Omnicom. One of these professors called the Seneca deal "a red flag," while the other expressed doubts about the venture's fair value. *Id*. at 506–7 (internal quotation marks omitted). Negative reports continued for several more days, culminating in a June 21 article in *Campaign* stating that questions were "now being asked about whether the [Seneca] deal was entirely at arm's length, whether it was adequately disclosed, and whether there might still be some lingering potential liabilities that might come back to haunt Omnicom in the future." *Id*. at 507.

Omnicom's share price declined throughout this period in June 2002. *Id*. at 505, 508. Amid the flurry of negative reports, the company's management made various statements to contradict the implication of irregularities. The share price did not recover, however, until later when a new auditor independently reviewed the accounting for the Seneca transaction and concluded that no accounting changes were required. *Id*. at 506–8.

The Securities Litigation

As Omnicom's share price fell, a class of investors filed suit, alleging that the company had committed fraud in connection with the Seneca transaction. On the issue of loss causation, the plaintiffs' expert witness, Scott Hakala, explained that the June 2002 news stories were "partially corrective disclosures" of Omnicom's alleged fraud in connection with the 2001 Seneca transaction. Dr. Hakala performed an event study and was prepared to testify that "the investing public's initial reactions" to these stories "in June 2002 were tied to the news of Omnicom's inappropriate accounting for investments in Internet-related entities and not to other news during that time period" and also that investors "legitimately feared that Omnicom's transfers of its Internet investments created the potential for losses and hidden liabilities and/or had allowed Omnicom to hide losses in the past." *Id*. at 508–9 (internal quotation marks omitted).

The district court granted, and the Second Circuit affirmed, summary judgment in favor of the company. *Id*. at 509. Both courts held that the plaintiff shareholders had failed to raise a material issue as to loss causation. *Id*. The Second Circuit reasoned that proximate cause was lacking because the "use of the Seneca transaction as an accounting method to remove losses from Omnicom's books was known to the market a year before Callander's resignation." *Id*. at 511. The events of June 2002 amounted to no more than "a negative characterization of already-public information." *Id*. at 512. The court explained that this kind of "negative journalistic characterization" cannot "constitute a corrective disclosure of anything but the journalists' opinions." *Id*. The same was true with respect to *The Wall Street Journal*'s quotations from the accounting professions—these "conclusory suspicions" added "nothing to the public's knowledge that the Seneca transaction was designed to remove losses from Omnicom's books." To demonstrate a "corrective disclosure" sufficient to show loss causation under Rule 10b-5, the court held, a plaintiff must show the revelation of "hard fact." *Id*. at 512. Here, the fact that *was* new—Callander's resignation—did not suffice. The court explained that "[i]n such circumstances, it is generally the facts underlying the fraud and resignation that [cause] a compensable investor's loss." *Id*. at 514. By contrast, issuers are not responsible for publicity surrounding the "reactions" of others:

Firms are not required by the securities laws to speculate about distant, ambiguous, and perhaps idiosyncratic reactions by the press or even by directors. To hold otherwise would expose companies and their shareholders to potentially expansive liabilities for events later alleged to be frauds . . . . *Id*.

The Significance of *Omnicom*

If the "loss causation" or "proximate cause" requirement in a Rule 10b-5 action is to have force, participants in the securities markets cannot be held liable for price fluctuations brought about by spin in the financial press. This is certainly true in cases like *Omnicom* where there has been a lapse of time between the factual disclosure and the start of accusations. But the time lapse in *Omnicom* is not a necessary factor.

It is well recognized that the opinions of analysts, journalists, and others can be capable of moving markets. *See, e.g.*, *Carpenter v. United States*, 484 U.S. 19, 22 (1987) (affirming conviction of journalist who traded in anticipation of his own financial advice column, where, due to the "column's perceived quality and integrity, it had the potential of affecting the price of the stocks which it examined"); Michael J. Borden, *The Role of Financial Journalists in Corporate Governance*, 12 Fordham J. Corp. & Fin. L. 311, 337 (2007) ("The downward momentum in Enron's share price was fueled by a series of news articles written by an ever-widening circle of journalists who followed Weil and McLean's trail."); Merritt B. Fox, *The Role of the Market Model in Corporate Law Analysis: A Comment on Weiss and White*, 76 Cal. L. Rev. 1015, 1035 (1988) ("The weighing of the commentators' opposing opinions by each trader and the averaging of those judgments in the pricing process will result in a market reaction. . . ."). But just as "negative journalistic characterization" did not "constitute a corrective disclosure of anything but the journalists' opinions" in *Omnicom*, the same would be true of similar opinions expressed close in time to an announcement of "hard fact."

Nor is it significant that the overheated rhetoric in *Omnicom* came primarily from the press. Alleged "corrective disclosures" may be made by purported "whistleblowers, analysts' questioning [of] financial results, resignations of CFOs or auditors, announcements by the company of changes in accounting treatment going forward, newspapers and journals, etc." *In re Enron Corp. Sec., Derivative & ERISA Litig.*, No. MDL-1446, 2005 U.S. Dist. LEXIS 41240, at *59 (S.D. Tex. Dec. 22, 2005). Such events may or may not be fairly or proximately attributable to an issuer's wrongdoing, and, in each instance, a court must scrutinize the claim to ensure that legal responsibility is limited to the proximate results of the defendants' own actions—not the actions of others who may be misinformed, acting from ulterior motives, or simply arbitrary.

In *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), the Supreme Court explained that the element of loss causation is rooted in the common law tort concept of proximate cause. *Id*. at 344–45 (2005). At common law, proximate or legal cause limits potential liability to the direct or foreseeable consequences of the alleged tort. *See* W. Keeton, D. Dobbs, R. Keeton, and D. Owen, *Prosser and Keeton on Law of Torts* § 42, at 273 (5th ed. 1984). Courts applying the federal securities laws should be vigilant to ensure that liability extends no further than what justice demands according to those principles. For example, a company may announce a restatement of financial results that it and its auditors regard as the correction of an innocent error, and the market may not react at all until it learns that the SEC is investigating. *See* Alistair Barr, *SEC Mulls Civil Suit Against RenaissanceRe CEO*, MarketWatch (July 25, 2005) (reporting in July 2005 that the SEC staff sent the company's CEO "a 'Wells Notice' indicating that they plan to recommend civil enforcement action against him for breaking federal securities laws" and shares "slumped 9 [percent] to close at $42.98, their lowest level since September 2003" although "In February [2005], RenaissanceRe said it was restating results from 2001, 2002, and 2003 to correct how it accounted for" the transaction at issue). In such circumstances, a court should scrutinize the plaintiff's case and hold the plaintiff's expert to a high standard to determine whether the market was reacting to new "hard facts" about the alleged fraud, or simply to the fear that officers would be subjected to a lengthy and burdensome process.

Government investigations and enforcement actions are subject to discretion and conflicting judgments and, perhaps more importantly, the actual or contemplated charges may be without merit. Similarly, the announcement by a firm of otherwise benign information is sometimes followed by hail of criticism or by alarm bells from market observers, be they major news media or analysts at large investment houses or anonymous commenters on Internet message boards. *In re Motorola Sec. Litig.*, 505 F. Supp. 2d 501, 513 (N.D. Ill. 2007) (information released in a proxy statement was characterized days later in a Bloomberg article, and only then did share price react). It may be difficult or impossible to judge the motivation or sincerity of a given source of opinion—yet the market may nevertheless react materially. *Dura* makes clear that the federal securities laws are not an insurance policy against the unpredictable effects of the actions of the countless relevant market actors. *See* 544 U.S. at 545. The Second Circuit explained in *Omnicom* that a rule of liability holding companies responsible for such losses would "undermine the very investor confidence that the securities laws were intended to support." 597 F.3d at 514.

Courts must be exceptionally careful in assigning blame in these situations. At times it may be difficult or impossible to separate the impact of "hard fact" from the impact of accompanying opinion or rhetoric. *Dura* specifically addresses the need to disentangle the true corrective disclosure from the other factors that may impact the market price of a security. 544 U.S. at 342–43. *Omnicom* and analogous cases present precisely that issue. It is the plaintiff's burden, at a minimum, to present evidence that some price drop was proximately caused by hard facts introduced to the market. If they cannot, as in *Omnicom*, the policies underlying the federal securities laws would be frustrated by allowing the case to proceed.

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