wiley

NEWSLETTER

Tenth Circuit Addresses Loss Causation and "Leakage" under *Dura*

March 2009

In a recent decision, the United States Court of Appeals for the Tenth Circuit held that a district court properly excluded the testimony of the plaintiffs' damages expert on loss causation, Dr. Blaine Nye, after concluding that his testimony was unreliable. *In re Williams Securities Litig.*, 2009 WL 388048 (10th Cir. Feb. 18, 2009). In so holding, the Tenth Circuit made two findings confirming that plaintiffs must engage in rigorous analysis to establish loss causation in securities litigation. First, the court held that in order to demonstrate loss causation based on leakage, plaintiffs must "show some mechanism for how the truth was revealed" and cannot simply argue that the drop in stock price demonstrates that the market "must have known" the truth. Second, the court held that when a plaintiff attempts to establish loss causation based on a corrective disclosure, it must "show both that corrective information was revealed and that this revelation caused the resulting decline." Thus, although the stock price of the company at issue plummeted from $28.50 at the start of the class period to $0.06 at the end of the class period, the Tenth Circuit held that plaintiffs had failed to offer reliable testimony that any of the drop was attributable to the alleged fraud.

The *Williams Securities Litigation* involved the collapse of a telecommunications company, Williams Communications Group (WCG), which was formed in the 1990s and filed for bankruptcy on April 22, 2002, when much of the telecommunications sector faced an adverse business climate. Plaintiffs filed suit against, among others, the former directors and officers of WCG, alleging that they made various misrepresentations concerning WCG's business.

At the close of discovery, defendants moved for summary judgment, arguing that plaintiffs, relying solely on the expert testimony of Dr. Nye, could not sustain their burden of proof on loss causation under *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 366 (2005). Dr. Nye offered two different theories of loss causation, but the Tenth Circuit agreed with the district court that neither of Dr. Nye's theories satisfied the threshold requirement for the reliability of expert testimony under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).

Dr. Nye first opined that the truth about WCG was leaked to the market over time, and that this was evident from the steady decline in WCG's stock price. As a threshold matter, the Tenth Circuit held that although a corrective disclosure is the "easiest" way to establish loss causation, plaintiffs can also meet their burden

based on a leakage theory without running afoul of *Dura*. However, the court held "any theory—even a leakage theory that posits a gradual exposure of the fraud rather than a full and immediate disclosure—will have to show some mechanism for how the truth was revealed. . . . The inability to point to a single corrective disclosure does not relieve the plaintiff of showing how the truth was revealed; he cannot say, 'Well, the market *must* have known.'" Instead, plaintiffs need to explain how and when information confirming the prior fraud reached the market. Thus, although the company need not be the source of the corrective disclosure, plaintiffs must be able to explain how the truth reached the market.

In the case of WCG, the Tenth Circuit explained that Dr. Nye had failed to identify any point at which the concealed risks materialized and reached the market. It rejected Dr. Nye's theory that, because WCG ultimately filed for bankruptcy, it was always valueless and the entire decline in stock price was a draining of the fraud premium. The court reasoned that Dr. Nye had failed to segregate the fraud leakage from "the 'tangle of factors' that affect a company's stock price" since "the same period witnessed the bankruptcies of WCG competitors, a decline in the telecommunications industry as a whole, and the overall market declines that followed the 9/11 terrorist attacks."

Dr. Nye also offered an alternative theory of calculating damages based on four corrective disclosures. The Tenth Circuit held that his theory on this issue was also unreliable. The court explained that "[a]ny reliable theory of loss causation that uses corrective disclosures will have to show both that corrective information was revealed and that this revelation caused the resulting decline in price. To be corrective, the disclosure need not precisely mirror the earlier misrepresentation, but it must at least relate back to the misrepresentation and not to some other negative information about the company."

The court explained that although Dr. Nye identified four disclosures that accompanied substantial stock drops, he could not tie the disclosures to any of the alleged misrepresentations or explain why they were "corrective." For example, the first corrective disclosure to which Dr. Nye pointed was an announcement by WCG's former parent that it would delay reporting year-end financial statements while it re-evaluated certain contingent liabilities associated with WCG. WCG's stock price fell 17.8 percent that day. However, the court noted that on that same day, Milberg Weiss filed the first complaint in the litigation. The court reasoned that the fact that Milberg Weiss had assembled its complaint that day "suggest[ed] that the market already had at least some knowledge of the fraud." In addition, the Tenth Circuit criticized Dr. Nye for failing to analyze the non-fraud disclosures that could have contributed to the stock drop, including the filing of the lawsuit, which was not a corrective disclosure.

Similarly, the court rejected Dr. Nye's effort to argue that WCG's announcements about filing for bankruptcy were corrective disclosures. The court rejected the plaintiffs' argument that WCG's bankruptcy filing was "within the zone of risk concealed" by the prior misrepresentations. According to the court, "there are too many intervening factors at play—including the total meltdown of the telecommunications industry—to allow Dr. Nye to reliably equate bankruptcy with the risks that the original misstatements concealed. To do so would transform the securities laws into the kind of downside insurance policy that *Dura* warned against."

The Tenth Circuit therefore concluded that the district court properly excluded Dr. Nye from testifying as to either of his theories. In the absence of such testimony, the court therefore held that plaintiffs could not meet their burden under *Dura*, and the court therefore properly granted summary judgment to the plaintiffs.