INSIGHTS

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IN THE COURTS

Tenth Circuit Rules on Loss Causation

by Theodore J. Boutrous, Jr., Julian W. Poon, and Joshua I. Wilkenfeld

On February 18, 2009, the US Court of Appeals for the Tenth Circuit issued a significant decision in *In re Williams Securities Litigation—WCG Subclass*[1] that clarified the contours of a plaintiff's "loss causation" burden under federal securities laws. In affirming dismissal of a massive class action, the Tenth Circuit held that to demonstrate that a particular loss was caused by fraud, a securities plaintiff (or plaintiffs' class) must demonstrate that the loss in share value was not caused by negative market, industry, or company-specific information unrelated to the specific allegations of fraud.

Facts and Procedural History of *Williams*

This case arose out of the collapse in share value and subsequent bankruptcy of Williams Communications Group (WCG), a telecommunications company. WCG had been formed earlier by The Williams Companies (Williams), a natural gas and pipeline company. WCG used decommissioned Williams pipelines and rights of way to construct a nationwide fiber-optic network. On July 21, 2000, the first day of the class period, Williams announced that it would effect a tax free distribution of the bulk of its shares in WCG to its shareholders; at the time, WCG's stock was trading at around $28.00 per share, down from a high over $60.00 in March, 2000. In April 2001, the spin-off was consummated, WCG ceased to be a Williams subsidiary, and WCG functioned as a separate company with its own board of directors.

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The intervening months proved rocky for WCG and the telecommunications industry. The market as a whole suffered in the wake of the September 11 terrorist attacks and the Enron bankruptcy, and the telecommunications industry in particular suffered industry-wide price declines. WCG stock suffered declines that paralleled the declines of other telecommunications companies, with WCG shares trading at $1.63 by January 29, 2002. WCG ultimately filed for bankruptcy on April 22, 2002. The first of several federal securities lawsuits were filed against WCG and Williams on January 29, 2002—the same day that Williams announced that it was delaying reporting its fourth quarter and 2001 year-end financial statements while it reevaluated the status of contingent liabilities it had with respect to WCG, and WCG announced that it was delaying its 2001 earnings report. Plaintiffs claimed that various defendants had intentionally misrepresented the financial well-being of WCG, and thereby inflated the price of WCG shares.

During the course of the litigation, the Supreme Court decided *Dura Pharmaceuticals, Inc. v. Broudo*,[2] which made clear that federal securities plaintiffs cannot recover simply by proving that they purchased at an inflated price, but must instead demonstrate "loss causation," *i.e.*, that plaintiffs' losses were caused by fraud. In an attempt to satisfy this burden, Plaintiffs submitted the testimony of their proposed loss causation expert, Dr. Blaine Nye. Defendants moved to exclude the proposed expert testimony under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,[3] and argued that Dr. Nye's testimony failed to reliably isolate losses caused by the revelation of fraud. The district court agreed and excluded the testimony. Because the proposed expert testimony constituted Plaintiffs' primary submission on loss causation, the district court granted summary judgment in favor of the defendants.

A Loss Causation Necessitates Evidence that Loss Caused by Fraud

In its first decision to apply *Dura*, the Tenth Circuit affirmed the grant of summary judgment against

the plaintiff class, and ruled that under *Dura* and *Daubert*, Plaintiffs did not submit reliable evidence establishing that their alleged losses were caused by fraud. The Tenth Circuit held that, under *Dura*, a plaintiff is required to "show that it was [a] revelation that caused the loss and not one of the 'tangle of factors' that affect price."[4]

Applying this principle, the Tenth Circuit rejected Plaintiffs' attempt to establish loss causation without identifying specific revelations of fraud. Plaintiffs claimed that the alleged "truth" about WCG "leaked" out over time, thus obviating the need to identify any particular disclosure of the alleged misrepresentations. The Tenth Circuit rejected this approach, however, because Plaintiffs failed to present evidence of specific revelations of fraud: "The inability to point to a single corrective disclosure does not relieve the plaintiff of showing how the truth was revealed."[5] Moreover, Plaintiffs' leakage theory failed because their expert could not "identify any causal link between the revelation of the truth and the decline in price."[6]

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The Tenth Circuit rejected Plaintiffs' loss causation theories because each failed to account sufficiently for the possibility that Plaintiffs' losses were caused by market, industry, or company-specific factors. For example, Plaintiffs attempted to satisfy loss causation by coupling the stock price decline of January 29, 2002, with the delay in earnings that was announced on that same day. But the Court rejected that effort because of Plaintiffs' failure to account for the possibility that other pieces of news from the same day were responsible for Plaintiffs' loss, including the filing of Plaintiffs' own class action. As the Court noted, "In fact, we know of at least one factor that was certainly at play—the filing of this lawsuit."[7] The Court held that Plaintiffs could not show loss-causation with evidence that "ma[kes] no attempt to show why . . . losses were entirely attributable to the revelation of fraud and nothing else."[8]

More generally, the Tenth Circuit rejected Plaintiffs' effort to define the alleged frauds so broadly as to render the loss causation element meaningless. In *Williams*, Plaintiffs "beg[an] with the assumption that WCG was virtually valueless" so as to support the argument that any negative information about WCG "drained the fraud premium."[9] But the Tenth Circuit held that *Dura* requires proof of a more precise relationship between a misrepresentation and a later decline in price: "We must again be careful not to connect each and every bit of negative information about a company to an initial misrepresentation that overstated a company's chances for success."[10]

Implications of *In re Williams*

Williams may well have important implications for securities class actions and other defendants, not just in the Tenth Circuit, but also across the country.

First, the case strongly supports the proposition that a plaintiff's loss causation burden requires affirmative evidence that a loss was not caused by non-fraud factors. Thus, when other possible explanations for a loss are available, a plaintiff's evidence may be deemed unreliable and inadmissible if it fails to account for those plausible non-fraud factors.

Second, *Williams* clarifies the utility of a "leakage" approach to loss causation. *Williams* strongly supports the argument that a plaintiff who claims that a "leakage" of information alerted the market to fraud must still identify specific pieces of information or disclosures that revealed past misstatements.

Third, *Williams* rejects efforts to define a misrepresentation so broadly as to render the loss causation requirement meaningless. In *Williams*, the plaintiffs claimed that the entire financial picture of WCG was fraudulent, so as to attempt to satisfy the loss causation element through any revelation of negative

information. But in rejecting the *Williams* plaintiffs' efforts as overly vague, the Tenth Circuit opinion demanded a much more precise connection between a particular fraud and a particular revelation.

NOTES

1. *In re Williams Securities Litigation—WCG Subclass*, Docket Number 07-5119.
2. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005).
3. *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).
4. *Williams*, Slip Op. at 13.
5. *Id.* at 15
6. *Id.* at 18.
7. *Id.* at 24.
8. *Id.*
9. *Id.* at 20.
10. *Id.* at 21.