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FOURTH CIRCUIT HOLDS THAT PARTIAL DISCLOSURES MUST RELATE BACK TO ALLEGED MISREPRESENTATIONS TO SATISFY LOSS CAUSATION REQUIREMENT UNDER FEDERAL SECURITIES LAWS

To Our Clients and Friends:

There was a time when a dramatic decline in the price of a company's stock would virtually guarantee a complaint alleging securities fraud. But it no longer suffices for federal securities plaintiffs simply to allege that they purchased defendants' stock at an "inflated" price; instead, they must now plead and prove "loss causation," *i.e.*, that their losses were caused by fraud. 15 U.S.C. § 78u-4(b)(4); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005). Nonetheless, plaintiffs, faced with market-wide stock drops and declines that are often unrelated to a particular company's public disclosures, frequently seize upon the Supreme Court's statement in *Dura* that the truth about a misrepresentation may "leak out," 544 U.S. at 342, to advance a theory of loss causation under which a series of "partial" disclosures allegedly prompted the drop in a company's stock price. The ability of plaintiffs to succeed on such a theory, however, may be circumscribed to some extent by a recent decision from the United States Court of Appeals for the Fourth Circuit--*Katyle v. Penn National Gaming, Inc.* (4th Cir. No. 09-2272, Mar. 14, 2011)--as well as by a Tenth Circuit decision that *Katyle* relied on--*In re: Williams Securities Litigation -- WCG* Subclass, 558 F.3d 1130 (10th Cir. 2009)--which we reported on in our February 19, 2009 Client Alert, "Tenth Circuit Issues Opinion Providing Robust Analysis of the Loss Causation Burden Under Federal Securities Law." In *Williams*, the Tenth Circuit affirmed the dismissal of a massive securities class action, holding that summary judgment was properly granted for the defendant in that case because of plaintiffs' failure to prove loss causation and demonstrate, by competent expert testimony or otherwise, that the alleged loss in share value was not caused by negative market, industry, or company-specific information unrelated to the specific allegations of fraud in the underlying complaint.

In *Katyle*, the Fourth Circuit reached a similar conclusion, albeit at the initial pleadings stage. In June 2007, during the time described by one analyst as the "peak" of the leveraged buyout ("LBO") boom, the defendant, Penn National Gaming ("Penn"), announced a definitive agreement to be acquired by private equity buyers in an LBO. The company announced that it expected to close the transaction in June 2008, subject to an extension in the event all state regulatory approvals had not been obtained. For the next few months, Penn issued press releases announcing state regulatory approvals and suggesting that the stock price remained fairly close to the announced LBO price, thereby implying that the market was confident that the deal would close. In the first quarter of 2008, however, the stock price began falling, despite the lack of negative news regarding Penn or the state of the LBO. In June, Penn issued a release stating that it had yet to secure the approval of the five remaining states, and that the closing date had been pushed back. According to the plaintiffs, however, while Penn continued to behave publicly as if the deal would close, by the beginning of the class period in March 2008, the company was involved in private discussions with the buyers and financing institutions in an attempt to either renegotiate the buyout price or terminate the deal. Penn announced the termination of the LBO in July 2008, which was the end of the class period alleged by plaintiffs. Plaintiffs claimed that the truth regarding the failed transaction "leaked out to the market through a variety of leaks," and

focused on delays in the state regulatory approval process and the company's failure to issue a press release when it received one of the approvals.

The district court held that none of the events relied on by plaintiffs constituted a "corrective disclosure," and none caused any significant decline in the company's stock price. It granted motions to dismiss and denied plaintiffs permission to file a proposed third amended complaint; plaintiffs then appealed the district court's denial of the motion for leave to amend and its refusal to vacate its judgment of dismissal. Earlier this month, the Fourth Circuit issued its published decision in *Katyle* affirming the district court's refusal to vacate its earlier judgment and its denial of plaintiffs' motion for leave to file a third amended complaint. Writing for the panel majority, Senior Circuit Judge Baldock (sitting by designation), joined by Judge Keenan, held that "the district court properly declined to disturb its judgment and allow amendment because the series of partial disclosures identified in the TAC [Third Amended Complaint] did not inform the market of Penn's alleged ongoing fraudulent omission."

Tracking the Tenth Circuit's decision in *Williams*, the panel majority also held that, while "[s]uch disclosures need not precisely identify the misrepresentation or omission; nor need the disclosure emanate from any particular source," "they must" nonetheless "reveal to the market in some sense the fraudulent nature of the practices about which a plaintiff complains," and that "[t]he disclosure must '*at least relate back to the misrepresentation* and not to some other negative information about the company'" (emphasis in original) (quoting *Williams*, 558 F.3d at 1140). And because the pleadings made clear that "[t]he disclosures did not 'relate back' to Penn's earlier omissions of the alleged truth because they did not even inferentially suggest that Penn's prior press releases were fraudulent and that the LBO would not close," the district court correctly granted Penn's motion to dismiss (citing *id.*). The panel majority also observed that "Plaintiffs have not pointed us to any decision that suggests a defendant's silence may constitute a corrective disclosure" (citing *Williams*, 558 F.3d at 1138). And it concluded as follows: "Because the series of six partially 'corrective' disclosures alleged in the TAC did not, gradually or otherwise, reveal to the market any undisclosed truth about Penn's undisclosed knowledge and resulting fraudulent omissions, any subsequent decline in Penn's share price cannot be attributed to those omissions."

In a separate opinion concurring in the judgment, Judge Wynn stated that he read Plaintiffs' complaint "more broadly" to allege "generally that Penn wrongly failed to disclose that the leveraged buyout would likely not close." "Nonetheless," Judge Wynn "agree[d] with the majority's judgment that Plaintiffs' Third Amended Complaint founders," "because the alleged corrective disclosures tell nothing of the alleged fraud, and, even assuming for the sake of argument that the alleged disclosures did reveal that the leveraged buyout would likely not close, the market had already come to that conclusion."

Just as the failure of the Penn LBO took place in the midst of the economic downturn of 2008 and the turmoil in the credit markets, in *Williams*, there were industry-wide stock price declines that took place in the wake of the September 11 terrorist attacks and the Enron bankruptcy, which plaintiffs' expert failed to reliably account for in purporting to isolate the losses caused by revelation of the fraud alleged by plaintiffs. Citing *Williams*, the Fourth Circuit held that not every announcement of bad news constitutes a corrective disclosure, as the disclosure must "at least relate back" to the alleged

misrepresentation, as opposed to some other negative information about the company (quoting *In re Williams*, 558 F. 3d at 1140). The information that "leaked out" in *Katyle* "did not even inferentially suggest that Penn's prior press releases were fraudulent" or that the LBO would not close. The proposed third amended complaint failed to show that the "new" information "revealed to the market something about the fraudulent nature of the press releases on which Plaintiffs purportedly relied to their detriment because only then could the press releases have caused Plaintiffs' economic loss." Moreover, none of the alleged corrective disclosures purported to "'reveal some then-undisclosed fact with regard to the specific misrepresentations alleged in the complaint'" (quoting *In re Omnicom Group, Inc. Sec. Litig.*, 597 F. 3d 501, 511 (2d Cir. 2010)). And it mattered not that the company allegedly did not issue a press release in late June when one state approved the LBO, because plaintiffs could not identify any decision that suggests "a defendant's silence may constitute a corrective disclosure."

Both *Katyle* and *Williams* teach us that, particularly in this age of turmoil in the markets and volatility in stock prices, defendants should have good grounds to defeat federal securities claims brought against them unless plaintiffs are able to allege and then prove specific facts demonstrating that the stock-price decline of a particular company can fairly be attributed to the disclosure of falsity in prior press releases or other statements by the company. The Fourth Circuit's recent decision in *Katyle* shows that, at the pleadings stage, simply alleging the existence of partial corrective disclosures does not enable plaintiffs to avoid the need to plead (and later prove) that those disclosures actually relate back to defendants' alleged misrepresentations. And the Tenth Circuit's decision in *Williams*, on which the Fourth Circuit relied extensively in *Katyle*, teaches that to defeat a motion for summary judgment, plaintiffs must be able to demonstrate at least the existence of triable issues of material fact showing that at least some identifiable portion of the complained-of stock-price drop can be directly attributed to defendants' earlier alleged fraud, and not to other causes, such as negative market, industry, or non-fraud-related company-specific information.

Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you work, the authors (Timothy K. Roake (650-849-5382, troake@gibsondunn.com) or Julian W. Poon (213-229-7758, jpoon@gibsondunn.com)), or any of the following members of the Securities Litigation Practice Group or Appellate and Constitutional Law Practice Group:

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