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Fraud-on-the-Market Use for Analysts' Claims

A recent case from the U.S. District Court for the Southern District of New York highlights the increasing role of early merits-based decision-making at the class-certification stage in §10(b) and Rule 10b-5 cases, as well as the difficulties class plaintiffs will face when alleging that misleading statements were made by market participants other than the issuer of the stock.

In *In re Credit Suisse First Boston Corp. Analyst Sec. Litig.*, 2008 U.S. Dist. LEXIS 14198 (S.D.N.Y. Feb. 26, 2008) (*CSFB*), Judge Loretta A. Preska refused to decide whether, as a matter of law, the fraud-on-the-market presumption of reliance—which is integral in proving classwide reliance and the predominance of common questions under Fed. R. Civ. P. 23(b)—can be applied in cases alleging misleading statements by analysts. However, the court did decide that plaintiffs at least would need to establish, at the class-certification stage, that the analysts' reports in fact had an effect on the stock price.

The court's subsequent analysis of the parties' competing expert reports on causation and its ultimate decision to decertify the class further highlight the difficulty plaintiffs may face in proving such an effect in order to meet the class-certification requirements under Rule 23.

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Background

Plaintiffs' motion for class certification in *CSFB* was initially granted by Judge John E. Sprizzo. Shortly after that ruling, however, the U.S. Court of Appeals for the Second Circuit decided *Miles v. Merrill Lynch & Co. (In re: Initial Pub. Offering Sec. Litig.)*, 471 F.3d 24 (2d Cir. 2006), which clarified the Second Circuit standard for determining class certification motions under Rule 23 and established, among other things, that courts can certify a class only after making a determination that each Rule 23 requirement has been met, even if the determination requires the resolution of factual disputes that overlap with merits issues. In light of *Miles*, defendants in *CSFB* moved for reconsideration, and a new hearing was ordered by Judge Sprizzo. The case was then transferred to Judge Preska.

Plaintiffs alleged that an analyst employed by defendants published three false and misleading reports shortly after the IPO of Lantronix Inc. in August 2000, including "buy" ratings for the stock. Defendants had also served as underwriters for the IPO and plaintiffs alleged that the analyst was pressured by defendants to give Lantronix a positive rating and quoted e-mail evidence in their complaint purporting to show that the analyst did not actually believe that Lantronix merited the recommendations in his reports.

Two years later, on Sept. 12, 2002, The New York Times published an article that, plaintiffs alleged, publicly revealed that defendants' analyst had been pressured to write positively about Lantronix back in August 2000, even though the analyst did not believe Lantronix merited a positive recommendation. Also on that day, Lantronix announced quarterly net losses of $72.5 million, and revenue of $11.5 million. Lantronix stock dropped from 70 cents to 50 cents that day and the next, a two-day drop of 28 percent. Plaintiffs alleged a class period starting on the day defendants' analyst's first Lantronix report was released on Aug. 30, 2000, through the day before the New York Times article was published on Sept. 12, 2002.

Fraud-on-the-Market and 'Miles'

The fraud-on-the-market doctrine established in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), is typically relied on by plaintiffs to establish classwide reliance in §10(b) and Rule 10b-5 class actions to meet the predominance requirement of Rule 23(b). To establish fraud-on-the-market, plaintiffs must prove that defendant made public material misrepresentations, and that the stock at issue was traded in an efficient market. *Basic*, 485 U.S. at 248 n.27. Once established, the doctrine creates a rebuttable presumption that "(1) misrepresentations by an issuer affect the price of securities traded in the open market, and (2) investors rely on the market price of securities as an accurate measure of their intrinsic value." *Hevesi v. Citigroup Inc.*, 366 F.3d 70, 77 (2d Cir. 2004). Absent the presumption, each plaintiff would be required to prove reliance, making it unlikely that the predominance requirement of Rule 23(b) could be met.

In *CSFB*, the Court noted that neither the U.S. Supreme Court nor the Second Circuit has expressly held that the reliance presumption can apply to statements made by market participants other than issuers of stock. Indeed, the Second Circuit has cast doubt on whether the reliance presumption can apply to opinions expressed by research analysts. In *Hevesi*, the Second Circuit, without deciding the issue, cited favorably to *West v. Prudential Securities Inc.*, 282 F.3d 935 (7th Cir. 2002), in which the Seventh Circuit refused to apply the presumption to nonpublic reports provided by a stockbroker to his clients. See *Hevesi*, 366 F.3d at 77; *West*, 282 F.3d at 938.

In *Miles*, the Second Circuit again cited to *West* in dicta, stating that "it is also doubtful whether the *Basic* presumption can be extended, beyond its original context, to [...] analysts' reports." *Miles*, 471 F.3d at 43. The key distinction between the statements of issuers and those of analysts cited by defendants in these cases is that the former are "uniquely authoritative" while the latter are "expressions of opinion." *Hevesi*, 363 F.3d at 21. The issue is currently before the Second Circuit awaiting decision in *In re: Salomon Analyst Metromedia Litigation*, Case No. 06-cv-3225.

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Rather than resolve the issue of whether, as a matter of law, the presumption should apply to analysts' reports, Judge Preska determined that, even if the doctrine could, in theory, extend beyond issuers' statements to statements made by research analysts, plaintiffs "failed to make a sufficient showing that it is applicable in this particular case," because they did not establish that the three analysts' reports at issue in fact affected the market for Lantronix stock. *CSFB* at *20-21.

Note that the *CSFB* court did not hold, as the Fifth Circuit has recently held, that loss causation must always be established for plaintiffs to get the benefit of the fraud-on-the-market presumption to support a Rule 23 motion. See *Oscar Private Equity Invs. v. Allegiance Telecom Inc.*, 487 F.3d 261, 265 (5th Cir. 2007), discussed in this column on June 13, 2007. Judge Preska's decision appears to be limited to a holding that, because "analyst statements are, at least in some respects, different from those of issuers," causation or market effect must be established at the class-certification stage where plaintiffs seek to apply the reliance presumption to analysts' statements. *CSFB* at *18. Indeed, some Second Circuit district courts have declined to follow the Fifth Circuit's holding in *Oscar* where the alleged fraud involved issuers' statements. See, e.g., *Wagner v. Barrick Gold Corp.*, 2008 U.S. Dist. LEXIS 15811, at *21-22 (S.D.N.Y. 2008); *Darquea v. Jarden Corp.*, 2008 U.S. Dist. LEXIS 17747, at *11 (S.D.N.Y. 2008).

Effect of Analysts' Reports

• ***Plaintiffs Could Not Establish That Analysts' Reports Affected the Market.*** After holding that plaintiffs were required to demonstrate that the analyst's reports affected Lantronix's stock price, the court waded directly into the conflicting expert evidence presented by the parties, ultimately siding with defendants' expert and holding that plaintiffs' were unable to prove causation.

• ***First,*** the court determined that the analyst's three reports had no effect on Lantronix's stock price at the time the reports were released in August and September 2000. There were no abnormal market returns after the first report was released and, although there was a slight upward movement in stock price after the second and third reports were released, both sides' experts had agreed that reports that simply reiterate previous ratings generally have no effect on stock price. *CSFB* at *23.

The court also rejected plaintiffs' argument that, because defendants failed to reveal their true opinion of Lantronix stock, this was an omissions case, and that reliance could therefore be presumed under the Supreme Court's holding in *Affiliated Ute Citizens of Utah v. United States,* 406 U.S. 128 (1972). The court held that plaintiffs' allegations were primarily based on several affirmative statements contained in the three analyst reports at issue and, under Second Circuit authority, *Affiliated Ute* does not apply where the omissions are not the focus of the allegations but have only exacerbated the misleading nature of affirmative statements. See *CSFB* at *25; *Starr ex. rel Estate of Sampson v. Georgeson S'holder Inc.*, 412 F.3d 103, 109 n.5 (2d Cir. 2005).

Plaintiffs argued in the alternative that even though the stock price did not move after the analyst's reports were released, the reports nevertheless had an effect by acting as a "booster shot" to maintain the stock price and prevent a slide. *CSFB* at *26. The court, however, rejected this theory, noting that plaintiffs' expert had not empirically tested for this kind of effect (and indeed admitted that the effect could not be tested for), and that it was entirely speculative. The court held that as a matter of law, "this price maintenance theory is patently deficient under *Miles*," which requires that determinations relevant to Rule 23 be based on relevant facts. Id. at *29.

The court highlights the difficulty plaintiffs face—even if the fraud-on-the-market presumption can theoretically be applied to misleading statements by analysts—in proving under 'Miles' that analysts' statements in fact affected the market price of the stock….

• ***Second,*** the Court found that, even if some effect could have been shown at the time the analyst's reports were released, the effect would have entirely dissipated by the time the loss occurred at the close of the class period, for two major reasons: 1) the analyst's reports were self-limited by an express disclaimer and a 12-month time limit, so that it would have been unreasonable to rely on them two years later; and 2) copious intervening information had been publicly released (including other analysts' reports more optimistic than defendants', numerous statements by Lantronix of actual and projected financials, Lantronix's restatement of financials and management change in May 2002, and the announcement of a formal SEC investigation in July 2002) that was completely inconsistent with the substance of the statements in defendants' reports. The court thus agreed with defendants' expert that "[i]t is inconceivable…that anybody [in 2002] would still be paying attention to those reports [from 2000]." *CSFB* at *39.

• ***Third,*** and finally, the court rejected plaintiffs' argument that the drop in Lantronix stock after the New York Times article criticizing defendants' analyst's research was published on Sept. 12, 2002 shows that the analyst's statements did still have an effect. Although the court had already concluded that plaintiffs failed to establish any effect when the reports were released and that any effect would necessarily have dissipated two years later, the court also agreed with defendants' expert that Lantronix's earnings announcement on the same day the article was published contained new negative information (despite an earnings pre-announcement one week earlier) that could account for the drop in the stock price. *CSFB* at *45.

In sum, because plaintiffs could not establish that the analyst's statements affected the market for Lantronix stock either at the time the statements were made or at the time the alleged loss occurred, the court granted defendants' motion for reconsideration and decertified the class.

Conclusion

Judge Preska's decision in *CSFB* highlights the early merits-based decision-making on class certification motions in light of *Miles*. The court waded directly into the parties' competing expert testimony to resolve whether plaintiffs could in fact establish market effect, and thereby trigger the fraud-on-the-market presumption of reliance. The court's analysis also highlights the difficulty plaintiffs will face—even if the fraud-on-the-market presumption can theoretically be applied to misleading statements by analysts—in proving under the *Miles* standard that analysts' statements in fact affected the market price of the stock (or overcoming rebuttal proof that it did not).

Since Judge Preska found the evidence here taken as a whole did not satisfy a minimal standard of proof regarding market distortion, she did not need to weigh in on the debate over whether the *Basic* presumption should apply at all to analyst statements or should require a higher standard of proof. See, e.g., *DeMarco v. Lehman Bros. Inc.*, 222 F.R.D. 243, 246-247, 249 (S.D.N.Y. 2004) (plaintiff must show an "analyst's statements materially impacted the market price in a reasonably quantifiable respect.").

The Second Circuit's upcoming decision in *In re: Salomon Analyst Metromedia Litigation*, should provide further guidance on the *Miles* standard and the applicability of the fraud-on-the-market doctrine to statements by analysts and, we predict, will not make the evidentiary hurdles any easier for the plaintiff bar.