Supreme Court Asked to Consider Critical Loss Causation Issues

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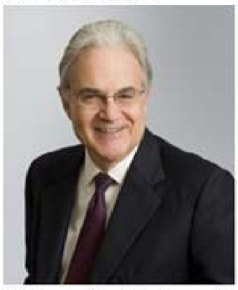

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Although the materiality of a misrepresentation or omission, reliance and loss causation are separate elements of a privately claimed violation of Section 10(b) and Rule 10b-5, their interrelationship is undeniable. However, to what extent, if any, are these legal concepts interdependent? Is the presumption of reliance (in an efficient market) appropriate in the absence of materiality? Does materiality exist in the absence of loss causation? Does loss causation depend upon immediate market assimilation and reaction to corrective disclosure, the required predicate of the efficient market hypothesis which forms the basis for the presumption of reliance? Intellectually, these concepts of materiality, the presumption of reliance and loss causation may be distinct, but pragmatically, the question is: Can you have one without the others?

The Supreme Court will have the opportunity to consider certain aspects of the interdependence of these concepts if it grants a writ of certiorari in *Apollo Group Inc., et al. v. Policemen's Annuity and Benefit Fund of Chicago* (unpublished) to review the U.S. Court of Appeals for the Ninth Circuit's concise but unenlightening reversal of the district court's entry of judgment as a matter of law for the defendants after an adverse jury verdict.

Apollo presents two questions as to which there is conflict among the circuits. First, where the plaintiff relies upon the efficient market theory to support a presumption of reliance, does the passage of more than a week following corrective disclosure before the market price declines preclude a finding of loss causation? Second, if the market price does not decline after the corrective disclosure, but declines based on a subsequent analyst report synthesizing and commenting upon the previously disclosed information, is the plaintiff precluded from relying upon the analyst's report as a corrective disclosure in order to prove loss causation?

Apollo, the parent corporation of the largest private university in the United States, was alleged to have failed to disclose, during analyst calls between March and August 2004, the content of a Department of Education report, received by Apollo in February 2004, which was critical of the university's recruiting practices. Apollo was not required to immediately disclose the report, and it chose not to do so.

During the summer of 2004, Apollo negotiated a settlement with the Education Department, which was disclosed by Apollo in a Sept. 7, 2004, press release. Between the issuance of the report in February and announcement of the settlement in September, Apollo was alleged to have made statements "at odds with the existence and contents of the Education Department report." Apollo was alleged to have downplayed the significance of the report in its disclosure of the settlement with the DOE. However, within a week of the announcement of the settlement with the Education Department, there were numerous news articles which revealed, in detail, the content of the Education Department report.
The articles, which appeared in The Wall Street Journal, the Chicago Tribune and other major newspapers, were critical of Apollo's recruiting practices and warned that a significant percentage of Apollo's revenues were imperiled with stricter regulatory control in the offing. Despite these disclosures, there was no statistically significant movement in Apollo's' share price.

Then, on Sept. 20, 2004, more than a week after these newspaper articles, and more than two weeks after Apollo's disclosure of the settlement with DOE, an analyst employed by UBS released two reports which downgraded her outlook for Apollo's stock and lowered UBS's rating from "Neutral" to "Reduce." The analyst's reports presented opinions, analyses and predictions about the potential impact of the Education Department report and discussed other unrelated negative developments. However, the analyst's reports did not disclose the actual content of the Education Department report, and her opinions and analyses referred only to previously disclosed facts. The day after the analyst's reports were released, there was a statistically significant drop in Apollo's stock price.

After a jury trial in which the jury returned a verdict in the plaintiff's favor, the district court granted Apollo's motion for judgment as a matter of law, holding that "[a] corrective disclosure that does not reveal anything new to the market is, by definition, not corrective." *In re Apollo Group Inc. Securities Litigation*, Master File No. CV04-2147-PHX-JAT, (D. Ariz. Aug. 4, 2008). The district court first rejected Apollo's argument that an analysis of previously disclosed facts can never be a corrective disclosure because there are situations in which the pertinent facts are obfuscated or are of such complexity as to "require someone to connect the dots for a bewildered market," although such situations "represent a very rare type of securities-fraud case, and would not be the rule." However, the district court accepted Apollo's argument that, in this case, the analyst's reports "were not necessary to reveal the fraud…because they did not provide any new, fraud-revealing analysis."

The Ninth Circuit reversed, concluding in a single paragraph of a three-page memorandum disposition, that "[t]he jury could have reasonably found that the [analyst's] reports following various newspaper articles were 'corrective disclosures' providing additional or more authoritative fraud-related information that deflated the stock price." In doing so, the Ninth Circuit relied, squarely and solely upon its decisions in *In re Gilead Scis. Sec. Litig.*, 536 F.3d 1049, 1058 (9th Cir. 2008) (later disclosure corrective when public initially "failed to appreciate [the] significance" of negative information) and *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 503 (9th Cir. 1992) (what market understands depends on "intensity and credibility" of information).

This rationale appears to be in tension with the efficient market theory upon which the presumption of reliance was established by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The efficient market theory, and thus the presumption of reliance, are predicated on the hypothesis that "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business." *Basic*, 485 U.S. at 241-42.

If there is no market reaction to the disclosed information in the form of a statistically significant change in the market price, then under *Dura Pharms. Inc. v. Broudo*, 544 U.S. 336, 342 (2005), there is no loss causation. The same absence of reaction may also indicate that the information was not material or that the market was not efficient and the presumption of reliance was misplaced. But how long is it appropriate to wait for a statistically significant reaction to a corrective disclosure?

Immediacy of Reaction

The Second, Third and Eleventh circuits require immediate price reaction to sustain loss causation in an efficient market. The U.S. Court of Appeals for the Second Circuit's decision in *In re Omnicom Grp. Inc. Sec. Litig.*, 597 F.3d 501 (2d Cir. 2010) reasoned that "[h]aving sought to establish investor reliance by the fraud-on-the-market theory, [the plaintiff] faces a difficult task," as it "must concede that the numerous public reports…were 'promptly digested' by the market and 'reflected in Omnicom's stock price' in 2001 while seeking to recover for a price decline a year later in 2002." Similarly, in *Teamsters Local 445 Freight Division Pension Fund v. Bombardier Inc.*, 546 F.3d 196 (2d Cir. 2008), the Second Circuit, affirming the denial of class certification, explained that the absence of a prompt price reaction following adverse disclosures was a key factor supporting a finding that the market was inefficient.

In *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000), then-Judge Samuel Alito explained that "when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm's stock." Thus, "if a company's disclosure has no effect on stock prices, 'it follows that the information…was immaterial as a matter of law.'" Id. (quoting *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997). Similarly, in *Thompson v. Relation Serve Media Inc.*, 610 F.3d 628, 689 (11th Cir. 2010), the court found that the plaintiff's theory of loss causation must fail if dependent upon "measur[ing] loss causation over twenty days after the market had learned of the alleged fraud."

In other circuits, the Fifth, Sixth and Ninth, a corrective disclosure may serve as a basis for liability even though the stock did not decline for weeks or even months after the corrective disclosure. In *Apollo*, the delay was more than a week. In *In re Gilead Sciences Securities Litigation*, 536 F.3d 1049 (9th Cir. 2008), the delay was 82 days. As the Fifth Circuit held in *Lormand v. US Unwired Inc.*, 565 F.3d 228 (5th Cir. 2009), at least in these circuits, "a delayed reaction can still satisfy the pleading requirements for 'loss causation.'" The Sixth Circuit, although quoting from the Third Circuit decision in *Burlington,* held, in *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2004), that "information important to reasonable investors (in effect, the market) is immediately incorporated into stock prices," but nonetheless measured market price reaction over a six-week period.

Subsequent Analyses

There is also a split among the circuits, with the Ninth Circuit standing alone, as to whether a recharacterization or analysis of previously disclosed information can be a corrective disclosure. In *Apollo*, the Ninth Circuit held that the analyst's reports could have been corrective disclosures because, although they added no new facts to the mix of available information, they were "more authoritative" and "amplified" the earlier disclosures.

In the Second, Third, Fourth, Fifth and Eleventh circuits, disclosures constituting merely "confirmatory information" with respect to facts already in the market do not qualify as corrective disclosures. Nor do disclosures providing "a negative characterization of already-public information," according to the Second Circuit in *Omnicom*, 597 F.3d at 512, qualify as corrective disclosures. Analogously, an interpretation of previously disclosed facts by an authoritative source has not been accepted as a corrective disclosure in *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 269-70 (Wall Street Journal interpretation of previously disclosed facts was not a corrective disclosure) or in *Omnicon*, 597 F.3d at 506-07 (accounting professor's opinion that a transaction raised a "red flag" was not a corrective disclosure).

Need for Supreme Court

Although the presumption of reliance based on the efficient market theory was established in *Basic*, the Supreme Court left open the question of "how quickly and completely publicly available information is reflected in market price." In *Dura*, the Supreme Court held that a plaintiff must prove the causal connection between the material misrepresentation and the loss and may recover only those economic losses actually caused by the misrepresentations.

In an efficient market, loss causation is dependent upon the effect of a corrective disclosure upon the market price. Thus, the timing of market "reaction" should be critical to the determination of whether the requisite causal connection exists. Equally important are the content and context of the disclosure. Is recapitulation of publicly known negative information and the expression of opinions enough to establish the link demanded by the Supreme Court in *Dura*?

Since it would be a Pandora's box to permit analysts' or others' opinions to do so, the Second Circuit's and similarly minded circuits' decisions should rule the day. Is a market-persuasive, fact-based analysis of the financial harm that will result from the factual disclosure different? We do not think so. Any standard that characterizes such an analysis as additional corrective information should be grounded in a finding that the initial company corrective disclosure was insufficient.

That would limit any expansion of the corrective disclosure concept to actual material factual information that, as a policy matter, corporate America should be required to disclose.

In *Apollo*, the allegation that the Education Department report was misdescribed or downplayed would necessarily be fully corrected by release of the report itself. To say analyses of the report are "corrective disclosures" is to say that Apollo was required to issue an analysis of the Education Department report. If so, that is a matter better handled as a regulatory disclosure policy issue and not in the context of a fraud analysis. In any event, a thorough consideration of the relationship among the presumption of reliance, materiality and loss causation by the Supreme Court would be welcomed.

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