The Legal Intelligencer

THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2006

PHILADELPHIA, MONDAY, SEPTEMBER 25, 2006 VOL 234 • NO. 58 $3.00 ALM

Does High Court Mean the Buyer Must Beware in Securities Markets?

BY JEFFREY A. BARRACK
Special to the Legal

The Supreme Court decision in *Dura Pharmaceuticals v. Broudo* has spurred much commentary since it came down in April 2005. The court addressed the pleading requirements for loss causation in fraud-on-the-market cases under the Securities Exchange Act of 1934.

Writing for the court, Justice Stephen Breyer explained that a plaintiff claiming securities fraud must show that the defendant's fraud caused her harm. To allege merely that a misrepresentation caused "an inflated purchase price will not itself constitute or proximately cause the relevant economic loss." *Dura* required the securities fraud plaintiff to allege in some fashion that "the truth became known" before "the share price fell."

Dura highlights the interplay in securities cases between economic loss and the fraud-on-the-market theory upheld in 1988 by the Supreme Court in *Basic v. Levinson* as a sufficient basis for a presumption of reliance: The fraud-on-the-market theory is based 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.

The theory posits that, unless defendant can show otherwise, "an investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed."

JEFFREY A. BARRACK *is a partner of Barrack Rodos & Bacine, where he represents plaintiffs in securities fraud, antitrust and consumer class action litigation. He may be reached by e-mailing jbarrack@barrack.com or by phone at 215-963-0600.*

While *Basic* dealt with "transaction" causation, the requirement that the plaintiff purchase securities at a price inflated by misrepresentation, *Dura* addressed "loss," or "proximate," causation — the causal connection between a defendant's material misrepresentations and plaintiff's losses. Breyer wrote that the securities fraud action provides redress only for the "loss the purchaser sustains when the facts become generally known and as a result share value depreciates." *Dura* requires a plaintiff to plead and prove losses attributable in some form of revelation of wrongfully concealed or misrepresented information.

Last spring, Columbia University Law Professor John Coffee explained in a column in the *New York Law Journal*, a publication of ALM, that *Dura* had become "a weapon" for defense counsel as a basis for new defense tactics. Coffee explained that because "market declines prior to the time of the corrective disclosure may escape liability, the issuer now has an incentive to modify its approach to disclosure, leaking out adverse information to the market on a not for attribution basis." If such information can "reach the market in vague and generalized terms … then defendants may be able to diminish expectations [and] break up the likely stock price decline." Coffee also explained the technique of "bundling … adverse and favorable information together" to lessen the blow of bad news.

Managing the dissemination of curative information using the tactics that Coffee discussed attenuates the impact of new information on stock price so that during any ensuing securities litigation it is more difficult to adduce evidence establishing proximate economic loss. Coffee explained that the "more adverse information reaches the market on a piecemeal basis, and preferably through third parties, the more aggregate price decline may resemble a series of plateaus" and avoid detection.

Thus, a series of "more nuanced" communications releasing material information in "an incomplete and piecemeal fashion" over time may create the false impression that factors other than a disclosed fraud were responsible for any price decline. Coffee's implicit message was caveat emptor; with these tactics in play, let the buyer beware. The need for that message is exactly what the policy of transparency embodied in our federal securities laws seeks to prevent.

The tactics identified by Coffee are not really new. But *Dura* reinvigorated litigation concerning the causal relationship between disclosure techniques and appreciation of new information by the market. For example, an August 2006 Southern District of Texas decision in the *Seitel* securities litigation involved a series of partial disclosures designed to minimize the impact of bad news. Defendants coupled the disclosures with positive statements designed to keep hidden the impact of bad facts. The court explained that the *Dura* standard was satisfied where the plaintiff's economic loss occurs as the "relevant truth begins to leak out" or "after the truth makes its way into the market place."

A December 2005 decision from the same district in *Enron* explained that differing disclosure techniques result in differing forms of impact upon the prices of publicly traded securities. "Thus besides a formal corrective

Securities Law continues on **8**

continued from **5**

disclosure by a defendant followed by a steep drop in the price of the stock, the market may learn of possible fraud through a number of sources, e.g., from whistleblowers, analysts' questioning of financial results, resignations of CFOs or auditors, announcements by the company of changes in accounting treatment going forward, newspapers and journals, etc."

Closer to home, New Jersey District Judge Faith Hochberg explained in her March 2006 *Bradley Pharmaceuticals* decision that "*Dura* did not address what types of events or disclosures may reveal the truth" or "that the disclosure [must] take a particular form or be of a particular quality." Cases like these stand for the proposition that *Dura* did not alter traditional methods of proving proximately caused economic loss even where disclosure techniques are used to minimize the impact of new information upon stock prices.

The econometric tool known as the "event study" is a forensic tool sensitive enough to scientifically support a finding of proximate economic loss where nuances have been created by the tactics described by Coffee. An event study is an accepted method used by economists to estimate the change in the market value of a company as reflected in the change in the market value of the company's equity.

The event study is based on the principle that publicly available information relevant to the valuation of a company is incorporated into stock prices such that the market price of a company's equity responds to new company-relevant information. An "event" is an informational disclosure, such as a press release or newspaper article. An "event window" is the period over time during which that disclosure is deemed to have an effect.

Economic and financial commentators like University of California Finance Professor Bradford Cornell have empirically validated the event study as a useful and reliable tool. The event study has been praised by courts as a thorough, sophisticated and well-substantiated method for detecting causation and measuring economic loss in securities litigation.

Thus, use of an event study supports the out-of-pocket measure of damages described by Judge Joseph Sneed in his 1976 concurring 9th U.S. Circuit Court of Appeals opinion in *Green v. Occidental Petroleum*. Northern District of California Judge Vaughn Walker therefore affirmed the utility of the event study in his August 1993 *Oracle* decision, explaining that an event study "is necessary more accurately to isolate the influences of information specific to [the issuer], which defendants allegedly have distorted."

Event studies are reliably used to address one-day events where there is a direct, clear disclosure of the falsity of prior representations. They are also used to address longer events where there is a series of nuanced communications that release information to create a false impression that factors other than a disclosed problem or fraud were responsible for any share price decline.

According to Cornell, "Rarely is one outright lie revealed through one correction." He explained that in order to address circumstances where "a fraud is revealed slowly over time," one need only "extend the observation window" to end "at a date when the analyst feels confident that most of the information is publicly available."

The impact of new information cumulates over the period of observation to accurately measure the market's appreciation of it. According to Cornell, the "length of the window depends on the facts of each specific case." Thus, it is appropriate, and at times necessary, to adjust the event window to enhance precision in detecting causation and measuring economic loss where the types of tactics described by Coffee are utilized.

In their April 1999 article on the use of event studies in the courtroom, David Tabak and Frederick Dunbar explain that a longer event window may be used to "include potential leakage" where it is likely that "information reached the market before the formal announcement," and to include "the market's ongoing adjustment to the news."

University of Colorado Finance Professor Sanjai Bhagat and Yale Law Professor Roberta Romano explained in *Empirical Studies of Corporate Law* that the event window should be extended during the period when "true information [is] being released" to allow for the market "to fully understand and incorporate the impact of the announcement." For example, a 2004 analysis of registration statement filings conducted in collaboration with faculty from top United States schools of economics, business and management, concluded that it is appropriate — under normal circumstances not otherwise complicated by allegations of fraud — to extend the event window "one week beyond the registration date to allow the information to disseminate."

The literature provides compelling support for using longer event windows where the types of tactics described by Coffee are present. Identification of a single event day is not always possible. Thus, where there is a rational basis to do so, economic theory provides for an extension of the window. Bhagat and Romano explain that an inability to "narrow the event interval does not indicate that the methodology cannot or should not be used."

This conclusion is underscored by Judge Shira Scheindlin's July 2005 ruling in *Fogarazzo v. Lehman Brothers* that analysis of the "cumulative" returns associated with events "provides a satisfactory methodology for determining loss causation." Thus, extending the event window to obtain confidence that most of the information is publicly available and appreciated is entirely consistent with, and not contrary to, the efficient market theory that "the price of a company's stock is determined by the available material information."

Certainly, if it makes sense to use a seven-day event window to allow for dissemination of information in a publicly filed registration statement, then it makes sense to do so when the tactics described by Coffee are employed.

The appropriate event window for any event study in a securities fraud action is from the moment of the initial materialization of the risk concealed by the defendant through the moment the market fully appreciates that risk. By using an event window appropriate for the circumstances of the particular case, the return of caveat emptor implied by Coffee in the wake of *Dura* may be prevented. •