When Is "News" Really News? Defining a Section 10(b) "Corrective Disclosure" under *Dura*

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In order to state a claim under Section 10(b) of the Securities Exchange Act of 1934, a plaintiff must, among other things, adequately allege a causal connection between the material misrepresentation and the loss, *i.e.* "loss causation." To plead loss causation, a plaintiff must allege either (1) "direct causation," a sufficiently direct relationship between the investment loss and the information misstated; (2) "materialization of risk," loss caused by the materialization of the concealed risk; or (3) a "corrective disclosure," false information revealed by a disclosure event.[1] Alleging a corrective disclosure is the most common method of pleading loss causation.

With respect to loss causation, the decision of the U.S. Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*[2] requires that a plaintiff demonstrate that the alleged fraud caused its economic loss by specifically linking a stock price drop to a misrepresentation that can be shown to have artificially inflated the stock price at the time of the investor's purchase. Loss causation may not be proven simply by pointing to a downturn in the stock price, however, since there may be a host of intervening factors, such as changes in economic conditions affecting the economy generally, the issuer's industry or the issuer's business specifically.

Accordingly, *Dura* requires a plaintiff to demonstrate that a specific public "corrective disclosure," unveiling an issuer's past misrepresentation, promptly led to a decline in stock price that cannot be attributed to other events or news. This is typically attempted using an "event study" prepared by an expert, such as a financial economist, that purports to measure the "excess stock price decline" attributable to a corrective disclosure by adjusting the stock's decline after the announcement for overall stock market movements and other factors specific to the issuer that are not relevant to the corrective disclosure.[3] Often a plaintiff will contend that the mere existence of an alleged excess stock price decline is itself evidence of the amount of the stock price inflation during the class period.

Because few securities class actions go to trial, there have been scant opportunities for judges or juries to analyze systematically specific loss causation scenarios. Nonetheless, a number of notable issues have surfaced that shed some light on the likely areas of dispute between litigants with respect to the quantification of damages cognizable under *Dura*.

Central among these is the question of what actually constitutes a "corrective disclosure" under *Dura*. For example, must a corrective disclosure be made by the issuer itself or are there situations in which a third party's statement, such as an analyst's report, qualifies? Need a corrective disclosure contain brand new information in order to result in cognizable damages or is it sufficient for a disclosure to analyze, digest, or reformat previously available data? How broadly must information be disseminated to constitute a "public" disclosure and therefore warrant the inference that the "news" caused the stock price's decline? Must the disclosure be clearly available to the public or is it sufficient for loss causation purposes to demonstrate that a substantial percentage of market participants were aware of the information?

With respect to the speaker of the corrective disclosure, courts appear to be arriving at a consensus that loss causation can indeed be premised on statements made by non-issuers. Indeed, a number of decisions endorse damage theories predicated on stock drops caused by analyst reports.[4]

Courts have recently rejected, however, a plaintiff's effort to premise damages on announcements or reports that merely analyze or interpret data that was already publicly available. In *In re Omnicom Group, Inc. Securities Litigation*,[5] the court dismissed the action holding that, because an analyst's report does not reveal new facts but merely analyzes and assesses a company based on the existing public record, it cannot, as a matter of law, constitute a corrective disclosure giving rise to cognizable damages under *Dura*. *In re Apollo Group, Inc. Securities Litigation*[6] reached the same outcome. In granting judgment for defendants as a matter of law, however, the *Apollo* court, was concerned it would "give companies the perverse incentive to indulge in opaque, piecemeal disclosures, specifically designed to avoid any market reaction to the news." It therefore rejected such a bright-line standard, concluding that there might indeed be a "very rare type of securities-fraud case" in which "facts are obfuscated in such a way, or are of such complexity, as to require someone to connect the dots for a bewildered market." Nonetheless, after carefully reviewing the analyst reports, the court concluded that they did not, in fact, "provide any new, fraud-revealing analysis" and vacated the judgment for plaintiffs.

Finally, there is the thorny problem of determining when information is sufficiently "public" for a court to conclude that there is indeed sufficient evidence to demonstrate that the corrective disclosure moved the market and therefore satisfies *Dura*. *Hunt v. Enzo Biochem, Inc.*,[7] is a case in point. In *Enzo Biochem*, defendants moved to dismiss a securities class action complaint on a number of grounds, including failure to adequately allege loss causation. Plaintiffs alleged that Enzo Biochem's stock price was artificially inflated as a result of misrepresentations made at the company's annual shareholder meeting regarding, among other things, the opening of additional clinics and progress with respect to clinical trials. Plaintiffs argued that such inflation was removed from the stock price as a result of either (a) the materialization of the concealed risk or, alternatively, (b) the disclosure to "a substantial segment of the institutional investment community" of a private placement memorandum from Union Bank of Switzerland, the company's investment banker, containing statements that allegedly contradicted representations made at the shareholder meeting.

With respect to the second theory, plaintiffs argued that, even though the private placement memorandum was not publicly available, its distribution to a sizeable portion of the market nonetheless caused an immediate stock drop and therefore constituted a corrective disclosure cognizable under *Dura*. The court, however, noted that plaintiffs failed to cite "any case supporting the proposition that disclosures may be corrective even when they are not public" and stated that "courts have routinely equated corrective disclosures with statements that have reached the public." Accordingly, whether a private placement memorandum not usually available to the public could be regarded as a corrective disclosure "appear[ed] to be an open question."

Drawing all inferences in plaintiffs' favor, the court concluded that both of plaintiffs' theories of loss causation, including a corrective disclosure premised on a non-public private placement memorandum, were sufficiently pleaded to survive a motion to dismiss. The court held that "logic dictates that the disclosure must, at the very least, be public enough to reach the market in order for the market to react negatively to the revelation of the truth underlying the alleged misrepresentations." It further held that the allegation, that the private placement memorandum acted as a corrective notice to a "substantial segment of the institutional investment community" when coupled with a spike in volume and a drop in stock price on the day of disclosure, satisfied pleading requirements with respect to loss causation.

At least in the context of a motion to dismiss, *Enzo Biochem* supports the contention that, to constitute a corrective disclosure under *Dura*, a statement by an issuer need not necessarily be disseminated and available to the entire public domain as long as it reaches a "substantial segment of the institutional investment community." What if, however, the statement is made, not by the issuer, but by an analyst or investor that has sussed out an alleged fraud on its own? In such a circumstance, would it still satisfy *Dura*'s corrective disclosure requirements if the statement was not made public, but was circulated only to select recipients?

The question is not merely academic; indeed, it has arisen in recent securities actions stemming from the stock options backdating scandal that broke in March 2006 with the publication by *The Wall Street Journal* of its Pulitzer Prize-winning article, "The Perfect Payday." The article, which highlighted the statistical likelihood that certain public companies had improperly backdated stock option grants in order to lower the exercise price without incurring a compensation expense, led some institutional investors and analysts to themselves conduct statistical analyses of the stock prices of companies in their portfolios or on their coverage lists in order to determine the likelihood that these issuers had also engaged in such unlawful conduct. These analyses identified numerous companies, not previously publicly identified, whose option grant data indicated a high statistical likelihood of backdating. Although the analyses were not made publicly available, they were sometimes selectively circulated to clients and other market participants. Assuming such dissemination coincided with a statistically significant deterioration in stock price, would a court find such an analysis sufficient to constitute a corrective disclosure under *Dura* notwithstanding the fact that it was (1) not in the public domain and (2) made by a non-issuer based only on pre-existing publicly available data? Perhaps, as in *Enzo Biochem*, the answer will turn on whether a "substantial segment of the institutional investment community" was aware of the disclosure. What if, however, a plaintiff can only tie a stock drop to trading by a single, but major, market participant, which on its own had concluded that fraud was afoot? Courts may soon be obliged to wrestle with such a fact pattern.

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[1] *See Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 161, 173-5 (2d Cir. 2005).
[2] 544 U.S. 336 (2005).
[3] An event study typically employs a regression study known as a market model that produces an equation describing the relationship between daily returns of a stock and returns on market or industry-specific indices. The predicted return is calculated by applying the market model to the day's index return. The excess return is the difference between the actual stock price return and the predicted return. If statistically significant, this excess return may be attributable to the corrective disclosure.
[4] *See e.g., In re eSpeed, Inc. Sec. Litig.*, 457 F. Supp. 2d 266 (S.D.N.Y. 2006); *Jefferson Ins. Co. v. Rouhana (In re Winstar Commc'ns.)*, No. 01-CV-11522 (S.D.N.Y. Feb. 26, 2006).
[5] 541 F. Supp. 2d 546 (S.D.N.Y. 2008) (Pauley, J.).
[6] Nos. 04-CV-2147, 04-CV-2204, 04-CV-2334, 2008 BL 169111 (D. Ariz. Aug. 4, 2008).
[7] 530 F. Supp. 2d 580 (S.D.N.Y. 2008) (Scheindlin, J.).