JONES DAY

MARCH 2011

HOW EFFICIENT IS THE MARKET? SUPREME COURT DECLINES TO ADDRESS PERMISSIBLE TIME LAG FOR SHOWING LOSS CAUSATION IN SECURITIES-FRAUD CASES

On March 7, 2011, the Supreme Court denied certiorari in *Apollo Group, Inc. v. Policemen's Annuity and Benefit Fund of Chicago.*[1] The case, coming out of the Ninth Circuit, presented two issues regarding corrective disclosures in securities-fraud litigation. This *Commentary* focuses on the first: When plaintiffs utilize the fraud-on-the-market theory to prove reliance in a Rule 10b-5 action, must the stock price decline immediately after the corrective disclosure for loss causation to exist?

THE FRAUD-ON-THE-MARKET THEORY

In 1988, the Supreme Court gave securities-fraud plaintiffs a tool that greatly reduced the challenge of proving their claims—the "fraud-on-the-market" theory.[2] To prevail on a securities-fraud claim under Rule 10b-5, plaintiffs must prove a material misrepresentation, scienter, a connection with the purchase or sale of a security, reliance, economic loss, and loss causation.[3] Before the Court's decision in *Basic v. Levinson*, class certification in securities-fraud actions was problematic because some circuits required plaintiffs to prove actual, individual reliance on a misrepresentation. The fraud-on-the-market theory, however, presumes that "the market is acting as the unpaid agent of the investor."[4] The theory assumes that where the market for a security is shown to be efficient, the market quickly and completely absorbs all public information and reflects it in the stock price.[5] As a result, under the fraud-on-the-market theory, a plaintiff need not prove individual

1 *Apollo Group, Inc. v. Policemen's Annuity and Benefit Fund of Chicago*, No. 10-649.

2 *See Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

3 *Dura Pharmaceuticals, Inc. v. Broudo*, 554 U.S. 336, 342 (2005).

4 *Basic*, 485 U.S. at 244.

5 *Id.* at 246.

© 2011 Jones Day. All rights reserved. Printed in the U.S.A.

reliance on a specific misrepresentation, as long as the security in question traded in an efficient market and the defendant is unable to rebut the presumption of reliance. However, a plaintiff still must prove loss causation, which requires proof that the stock price declined after a corrective disclosure.

THE ISSUE

In *Apollo Group*, the plaintiffs relied on the fraud-on-the-market theory to establish reliance, but the stock price did not decline until two weeks after the initial corrective disclosure was made. Thus, the issue presented was, when a plaintiff utilizes the fraud-on-the-market theory, which is predicated on an efficient market, how long after the corrective disclosure may the stock price decline for the loss causation element of a Rule 10b-5 claim to be satisfied?

THE SPLIT

The five circuits that have addressed the timing of the loss are divided. The Second and Third Circuits have held that a securities-fraud plaintiff must demonstrate that the market immediately reacted to the corrective disclosure.[6] Conversely, the Fifth, Sixth, and Ninth Circuits have held that the price decline may occur weeks or even months after the initial corrective disclosure.[7] By denying certiorari in *Apollo Group*, the Supreme Court left this split unresolved.

The courts that require immediate market reaction have provided two rationales. The Third Circuit reasoned that if an efficient market does not promptly react to a corrective disclosure, the prior misrepresentation must not have been material.[8] Thus, where the market's reaction is not immediate, the court will not even reach the question of causation because a material misrepresentation is absent. Approaching the issue from a different angle, the Second Circuit refused to find loss causation and declined to allow a plaintiff to recover for a stock price drop that came more than a year after the corrective disclosure. The court highlighted the inconsistency that exists when a plaintiff "must concede that the numerous public reports ... were 'promptly digested' by the market and 'reflected ... in [the] stock price' in 2001 while seeking to recover for a stock price decline a year later."[9]

On the other hand, the Fifth, Sixth, and Ninth Circuits have found materiality and loss causation in cases where the plaintiff invoked the fraud-on-the-market doctrine, even when the price decline occurred long after the corrective disclosure. The Fifth Circuit has found that "a delayed reaction can still satisfy the pleading requirements for 'loss causation.'"[10] In calculating loss, the Sixth Circuit has considered market fluctuation during a six-week period after a corrective disclosure,[11] and the Ninth Circuit has held that a loss that occurs 82 days after the corrective disclosure may still be caused by that disclosure.[12]

The petitioner in *Apollo Group* (the defendant in the trial court) advanced an argument similar to the one the Second Circuit articulated. It contended that an assertion that a loss occurring weeks or months after a corrective disclosure was caused by that disclosure is inconsistent with the fraud-on-the-market theory, which presumes that all public information is *quickly* and completely absorbed by the market.[13] Either the market is efficient or it is not. The market cannot both swiftly absorb false or misleading information when the

6 *See In re Omnicom Group, Inc. Secs. Litig.*, 597 F.3d 501 (2d Cir. 2010); *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000).

7 *See Lormand v. U.S. Unwired, Inc.*, 565 F.3d 228 (5th Cir. 2009); *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2004); *In re Gilead Sciences Secs. Litig.*, 536 F.3d 1049 (9th Cir. 2008).

8 *See Oran*, 226 F.3d at 282 ("[W]hen 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.").

9 *Omnicom*, 597 F.3d at 511.

10 *Lormand*, 565 F.3d at 266 n.33.

11 *City of Monroe Emps. Ret. Sys.*, 399 F.3d 651.

12 *Gilead*, 536 F.3d at 1058.

13 Petition for Writ of Certiorari, *Apollo Group, Inc. v. Policemen's Annuity and Benefit Fund of Chicago*, (No. 10-649).

misrepresentation occurs (thus eliminating a plaintiff's burden of proving individual reliance) and then slowly react to a corrective disclosure (allowing a plaintiff to recover for a loss that occurs long after the disclosure is made). As the Third Circuit noted, "[a]n efficient market for good news is an efficient market for bad news."[14]

In addition to the inconsistency argument the petitioner advanced, the time-sensitive nature of causation supports a standard requiring immediate reaction. When a stock price declines immediately after a corrective disclosure, it is fair to assume that the decline was caused by the disclosure (absent other, simultaneous non-fraud-related disclosures or events). However, as days, weeks, or months go by, the number of potential causes of a price decline grows. Any connection between the disclosure and the decline becomes increasingly attenuated as time passes. To allow plaintiffs to recover for fraud without genuine proof of loss causation not only disregards the basic elements of the claim but also expands the reach of Rule 10b-5 beyond its drafters' intent. The Supreme Court is aware of that risk, having already observed that "[p]rivate securities fraud actions … if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law."[15] Underscoring the purpose and importance of the loss causation element, the Court has stated that it is this element that prevents Rule 10b-5 from acting as "investment insurance" against business disappointments or market fluctuations.[16]

The timing requirement of loss causation under the fraud-on-the-market theory has great significance for publicly traded corporations and their counsel. The Court's refusal to resolve the current split subjects corporations to different standards and varying liability exposure depending solely on where a Rule 10b-5 class action is filed. And, because the Ninth Circuit accounted for nearly one-quarter of the securities class actions filed between 1997 and 2008, the impact of its plaintiff-friendly approach can hardly be ignored.[17]

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Geoffrey J. Ritts
Cleveland
+1.216.586.7065
gjritts@jonesday.com

Marjorie P. Duffy
Columbus
+1.614.281.3655
mpduffy@jonesday.com

Sarah M. Paynter
Columbus
+1.614.281.3875
spaynter@jonesday.com

---

14 *In re Merck & Co., Inc. Secs. Litig.*, 432 F.3d 261, 271 (3d Cir. 2005).

15 *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 313 (2007).

16 *Dura*, 544 U.S. at 345.

17 See Alexander Aganin, Cornerstone Research, *Securities Class Action Filings 2009: A Year in Review* 25 (2010).

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.