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Loos is Lost: Loss Causation under Federal Securities Laws after Loos v. Immersion Corp

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I. INTRODUCTION

"*To 'touch upon' a loss is not to cause a loss, and it is the latter that the law requires*."[1]

In February of 2014, the Ninth Circuit Court of Appeals held in *Loos v. Immersion Corp.*,[2] that under a securities fraud claim, "the announcement of an investigation, standing alone, is insufficient to establish loss causation."[3] The court followed in line with several other circuit courts, which have denied a cause of action to plaintiffs who do not support their claim with greater evidence than a drop in stock price and the subsequent announcement of an internal or external investigation. This article will consider the relevant case history leading up to *Loos*, as well as why the Ninth Circuit came to an incorrect conclusion given the purpose of securities fraud claims.

As will later be revealed, most of the circuits (including the Ninth Circuit after *Loos*) recently interpreted the securities fraud statute as having strict loss causation requirements.[4] This interpretation results from a history of frivolous securities fraud claims in an attempt to win settlement money from corporations. The strict standard adopted by *Loos* and other courts is an overreaction to the threat of frivolous claims. An investigation and a relating stock price decrease should be enough to fulfill the loss causation requirement at the pleading stage of a securities fraud claim.

Part II of this note will describe the history of the Securities and Exchange Act of 1934's Rule 10(b) and the relevant cases that provide the foundation for the Loos decision. This section will also explain the circuit split regarding whether an investigation is enough to plead loss causation and provide a description of the facts leading up to the *Loos* decision, including the

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[1] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343, 125 S.Ct. 1627, 1632 (2005).
[2] 2014 U.S. App. LEXIS 17813 (9th Cir. 2014)
[3] Loos v. Immersion Corp., 2014 U.S. App. LEXIS 17813 at *2-3 (9th Cir. 2014) (hereinafter short name referred to as "Loos").
[4] Cite either the circuit court cases as examples or cite the portion of your article where this is described, or both.

relevant factual findings of the district court that were conceded by the appellate court. Part III will analyze the Ninth Circuit's decision and its impact on the law of securities fraud. This section will compare the Loos analysis with the approach adopted by other courts. Part IV will summarize the main arguments within the circuit split and propose a more equitable solution.

II. LEGAL FRAMEWORK & BACKGROUND

A. Background on *Loos*: Immersion Corp. Stock Dip and Investigation

Despite a drop in stock price and the announcement of an internal investigation, the Ninth Circuit in *Loos* held that the plaintiffs did not adequately plead the *loss causation* requirement of the federal securities fraud statute. Immersion Corporation ("Immersion") is publicly traded on the NASDAQ stock exchange.[5] The company develops and licenses "haptics" technology, which creates tactile feedback for handheld and medical electronic devices.[6]. In late 2009, John Loos and other investors,[7] filed a class action against Immersion in the Northern District of California for "violations of Sections 10(b), 20(a) and 20A of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission's implementing regulations."[8] The company and five of its executives were named as defendants.[9]

The District Court granted the Defendants' motion to dismiss for failure to adequately plead scienter and loss causation.[10] But the court granted Plaintiffs' leave to amend. The Plaintiffs then amended the complaint, with the same causes of action.[11] The district court again

[5] *Id*. at *3-4.
[6] *Id*. Specifically, the technology creates a "pulse" when a button is pressed on the screen of a device. *Id*.
[7] Cite to complaint. (hereinafter collectively referred to as "Plaintiffs").
[8] *Id*.
[9] *Id*. (hereinafter collectively referred to as "Defendants").
[10] Loos v. Immersion Corp., 2014 U.S. App. LEXIS 17813 at *4-5 (9th Cir. 2014).
[11] *Id*.

granted the Defendants' second motion to dismiss for failure to meet the previous deficiencies.[12] The Plaintiffs then appealed to the Ninth Circuit Court of Appeals.[13]

From the beginning of Immersion's public offering in 1999, until the end of 2006, the company was not profitable.[14] Immersion reported its first profitable quarter in the first quarter of 2007 ("1Q07") after receiving a $150 million settlement in a patent infringement claim.[15] In an attempt to satisfy shareholders, the company disclosed that it would invest the funds in growth initiatives to insure profitable quarters in the future.[16] In its 2Q07 disclosure and press release, Victor Viegas, Immersion's CEO and a named defendant in *Loos*, claimed that the company had two successful quarters in a row due to strong sales in the Medical Division.[17] He also indicated that revenue grew 19% in 2Q06 and expected further growth through international sales in China.[18]

In the 3Q07 press release, Viegas noted another profitable quarter and claimed revenue grew 39% over 3Q06.[19] Immersion again boasted profitability in 4Q07.[20] However, in 2Q08, the company announced a net loss of $3.1 million.[21] Immersion attempted to highlight the growth in revenues in 2007.[22] Nonetheless, the company reported a loss of $4.3 million in 3Q08.[23] The company continued to focus on revenue growth, which exceeded $10 million

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[12] *Id*.
[13] *Id*.
[14] Loos, 2014 U.S. App. LEXIS at *5.
[15] Id.
[16] Loos v. Immersion Corp., 2014 U.S. App. LEXIS 17813 at *6 (9th Cir. 2014).
[17] Loos, 2014 U.S. App. LEXIS at *6-7.
[18] Id.
[19] Id.
[20] Loos v. Immersion Corp., 2014 U.S. App. LEXIS 17813 at *7-9 (9th Cir. 2014).
[21] Id.
[22] Id.
[23] Id.

quarterly.[24] The company reported a $7.1 million loss in 4Q08 and a $7.5 million loss in 1Q09.[25] Finally, the company admitted a decrease in revenues.[26]

On July 1, 2009, Immersion announced that the Audit Committee of the Board of Directors would be conducting an internal investigation into previous revenue transactions in its Medical division.[27] The company's shares proceeded to drop 23% that day.[28] On August 10, 2009, Immersion advised investors not to rely on its prior financial statements.[29]

In its amended Form 10-K/A filed with the SEC, the company admitted to errors in recording revenue and recognizing sales prematurely, violating generally accepted accounting principles ("GAAP") regarding three types of orders: (1) a "side agreement" with Chinese customers for unauthorized shipping and payment terms; (2) products that were either unavailable or not fully in the development stage at the time of sale; and (3) orders not delivered in time, contained non-standard terms, or "lacked probable collectability."[30] As a result of these errors, Immersion restated its earnings for 2006, 2007, 2008 and 1Q09.[31] The most significant impact of the restatement was on fiscal year 2008, in which Immersion reversed $623,000 in medical sales revenue and deferred another $3 million to later periods.[32] Although these figures might lead a reasonable person to infer that Immersion Corp.'s fraudulent conduct caused the investors' financial injuries, the court held otherwise.[33]

B. A Brief and Relevant History of the Securities and Exchange Act of 1934

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[24] Id.
[25] Loos v. Immersion Corp., 2014 U.S. App. LEXIS 17813 at *9 (9th Cir. 2014).
[26] Id.
[27] Loos, 2014 U.S. App. LEXIS at *9-10.
[28] Id.
[29] Id.
[30] Loos v. Immersion Corp., 2014 U.S. App. LEXIS 17813 at *10-11 (9th Cir. 2014).
[31] Id.
[32] Id.
[33] Loos, 2014 U.S. App. LEXIS at *2-3.

1. Securities Exchange Act of 1934 § 10(b) and SEC Rule 10b-5

Due to the Great Depression and market crash of October 1929, political pressure for securities regulation resulted in the Federal Securities Act of 1933.[34] The 1933 Act regulates public offerings and the sale of securities in interstate commerce.[35] The Act emphasizes disclosure and is influenced by the philosophy of Justice Brandeis: "Sunlight is said to be the best of disinfectants: electric light the most efficient policeman."[36] The 1933 Act is complemented by the Securities Exchange Act of 1934, which acts as the enforcement mechanism to the mandates of the 1933 Act.[37] The Exchange Act is essentially "a laundry list of problems for which Congress articulated neither the means nor the end objective."[38] The 1934 Act establishes the Securities and Exchange Commission ("SEC") and delegates authority to the SEC to deal with securities issues.[39] While the Securities Act is concerned with the initial distribution of securities to investors, the Exchange Act focuses on trading markets and the parties involved in these markets, requiring continuous disclosure by participants.[40]

The primary tool for enforcing the proper distribution of information to investors is Rule 10b-5, authorized under Section 10(b) of the Securities Exchange Act.[41] The Rule was adopted in 1942 pursuant to the SEC's authority to proscribe rules to prevent deceptive practices in connection with the purchase or sale of securities.[42] The scope of the Rule is meant to be broad and covers conduct by any corporation "so long as the misconduct is intentional and truly

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[34] COX, HILLMAN & LANGEVOORT, SEC. REG. CASES AND MATERIALS § 1[B][1][a] 5 (7th ed. 2013).
[35] Id.
[36] Id (*citing* L.D. BRANDEIS, OTHER PEOPLE'S MONEY 62 (1914)).
[37] Id at § 1[B][1][b] 8.
[38] Id.
[39] Id.
[40] Id at 9, 10.
[41] Id at § 13 695.
[42] Id.

deceptive in nature."[43] Enforceable both publicly and as a private right of action, the Rule is the central antifraud provision of the federal securities laws.[44]

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[45] Additionally, SEC Rule 10b-5 (implementing § 10(b)) prohibits the following "in connection with the purchase or sale of any security":

(a) To employ any device, scheme, or artifice to defraud;

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person[.][46]

There are six elements to securities fraud claim pursuant to §10(b) and Rule 10b-5:

1. A material misrepresentation or omission;
2. Scienter (i.e. a wrongful state of mind);
3. A connection between the misrepresentation and the purchase or sale of a security;
4. Reliance upon the misrepresentation (in "fraud-on-the-market" cases, presumption that price of stock reflects all public information)
5. Economic loss; and

[43] Id at § 13 696.
[44] Id.
[45] 15 U.S.C. § 78j(b).
[46] 17 C.F.R. §240.10b-5.

6. Loss causation.[47]

The sixth element, *loss causation,* is defined as the "causal relationship between a material misrepresentation and the economic loss suffered by an investor."[48] Loss causation can be established by a revelation of fraudulent activity.[49] Plaintiffs commonly establish loss causation by showing the following:

> (1) identifying a 'corrective disclosure' (a release of information that reveals to the market the pertinent truth that was previously concealed or obscured by the company's fraud); (2) showing that the stock price dropped soon after the correct disclosure; and (3) eliminating other possible explanations for this price drop, so that the factfinder can infer that it is more probable than not that it was the corrective disclosure—as opposed to other possible depressive factors—that caused at least a 'substantial' amount of the price drop.[50]

The Fifth Circuit has a different threshold for establishing loss causation, called *materialization of the risk*.[51] The plaintiff must prove that the defendant's fraud caused a material risk to go undisclosed.[52] If the misrepresentation "touches upon the reasons for the investment's decline in value" then the plaintiff can prove loss causation.[53]

One might inquire as to the purpose of the loss causation requirement, given that economic loss must be fulfilled in any case. The intent of the loss causation requirement is to

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[47] Citation needed.
[48] *Loos*, 2014 U.S. App. LEXIS 17813 at *13 (*citing* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 342, 125 S. Ct. 1627, 161 L. Ed. 2d 577 (2005)).
[49] Metzler Inv. GMBH v. Corinthian Colls., Inc., 540 F.3d 1049, 1062 (9th Cir. 2008).
[50] Jonathan N. Eisenberg, *Litigating Securities Class Actions* § 2.06 (Matthew Bender) (*quoting* FindWhat Investor Group v. FindWhat.com, 658 F.3d 1282, 1311 n.38 (11th Cir. 2011)).
[51] Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 820-21 (2009).
[52] Id.
[53] Id.

prevent Section 10(b) from becoming "an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission."[54] Valuation in securities litigation is highly complicated and often speculative.[55] Stock prices are considered "a dynamic, not a static, concept and the market may re-evaluate and re-price a stock on a daily, hourly or even momentary basis."[56] An expert's opinion may be influenced by subsequent stock prices.[57] This is particularly likely when the price drop occurs immediately following a disclosure of allegedly fraudulent conduct.[58] Thus, one scholar speculates that loss causation solves an evidentiary problem.[59]

Contrary to its nomenclature, *loss causation* in securities fraud is not based on tort principles and did not originally appear in the text of the statute.[60] The courts previously used "federal common law" to define a securities fraud claim.[61] The elements of the claim are mainly judge-made law.[62] Early securities fraud litigation focused on the *reliance* element in order to establish a sufficient nexus between the fraud and purchase of the security.[63] The loss causation requirement was not codified until 1995.[64] Loss causation became an element of a securities fraud claim when Congress passed the Private Securities Litigation Reform Act (PSLRA) in

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[54] William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors, § 13.05 (8th ed. 2011) (*quoting* Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981), *rev'd in part on other grounds*, 459 U.S. 375 (1983)).
[55] Id.
[56] Id.
[57] Id.
[58] Id.
[59] Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 845-46 (2009).
[60] Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 820-21 (2009).
[61] Id.
[62] Id.
[63] Ann Morales Olazabal, Loss Causation in Fraud-on-the-Market Cases Post Dura Pharmaceuticals, 3 BERKELEY BUS. L.J. 337, 343 (2006).
[64] Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 820-21 (2009).

1995.[65] In an effort to curb frivolous securities fraud claims, the PSLRA required pleading with particularity. [66]

Some courts analogize loss causation to proximate cause and look to whether the loss suffered was a foreseeable result of the fraud.[67] Other courts place the burden on the defendant to "sever" the link between the misrepresentation and the price drop or leave causation up to the jury.[68]

The problem with the courts' use of causation in securities cases: the courts are relying on negligence principles while securities fraud is an intentional tort.[69] Causation is used in negligence cases as a "process of logical determination" for deciding whether the plaintiff's injuries were too attenuated from the defendant's actions.[70] In intentional tort cases, the causation requirement is usually easier to fulfill since it is assumed that there is a close link, both temporally and conceptually, between the wrongful conduct and the harm.[71] Courts also see the defendant as blameworthy and are less concerned with the scope of harm.[72] There is also little "risk of inefficient overdeterrence" for imposing liability for intentional torts.[73] Thus, the purpose of loss causation is to take focus away from the harm itself. For example: it is irrational to hold a lying executive during a rising stock market accountable while an executive who commits fraud just before a stock market crash escapes liability.[74]

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[65] *See* Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, § 101(b), 109 Stat. 737 (1996).
[66] *Id.* at § 105.
[67] Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 821 (2009).
[68] *Id.* at 826-27.
[69] *Id.* at 840.
[70]21-101 FRUMER & FRIEDMAN, PERSONAL INJURY ACTIONS, DEFENSES, DAMAGES § 101.6 (Matthew Bender Rev. Ed.) [3][a] n. 50 (*citing* Norwood v. City of New York, 95 Misc. 2d 55, 406 N.Y.S. 2d 256 (Civ. Ct. Queens County 1978)).
[71] Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 832 (2009)..
[72] Id.
[73] Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 832 (2009).
[74] *Id.* at 840.

2. Supreme Court Case Law

a. Dura Pharmaceuticals, Inc. v. Broudo

In *Dura Pharmaceuticals,* the Supreme Court held that a plaintiff cannot satisfy the loss causation requirement for securities fraud by merely alleging that the price of the security at the date of purchase was inflated due to a misrepresentation.[75] The plaintiffs in *Dura Pharmaceuticals*[76] claimed that the company made false statements regarding the profitability of its prospective asthmatic spray device.[77] Although the price of the shares fell, it ultimately recovered within one week.[78]

The *Dura Pharmaceuticals* Court set down the basic elements of the securities fraud statute: "Section 10(b) of the Securities Exchange Act of 1934 forbids[:] (1) the use or employ[ment] . . . of any . . . deceptive device, (2) in connection with the purchase or sale of any security, and (3) in contravention of Securities and Exchange Commission rules and regulations."[79] The Court also defined securities fraud as "among other things, the making of any untrue statement of a material fact or the omission of any material fact necessary in order to make the statements made . . . not misleading."[80] *Dura Pharmaceuticals* noted that the courts have implied a private damages action from these statutes, which is similar to "common-law tort actions for deceit and misrepresentation."[81]

According to the Court, for publicly traded securities, a cause of action requires (1) a material misrepresentation or omission; (2) scienter; (3) a connection with the purchase or sale of

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[75] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 338, 125 S.Ct. 1627, 1629 (2005).
[76] Id. at 339 (plaintiffs included investors in the stock of Dura Pharmaceuticals Corp.).
[77] Id.
[78] Id.
[79] Dura, 125 S.Ct. at 1630-31 (2005)(*citing* 15 USC § 78j(b))(internal quotation marks omitted).
[80] *Id.* (*citing* 17 CFR § 240.10b-5 (2004))(internal quotation marks omitted).
[81] Id. The right to private damages from an act of securities fraud holds a similar *function* to common law tort. However, as mentioned earlier (n. 60, 61), the private right of action for securities fraud is based on judge-made law, which focused on reliance rather than causation.

a security; (4) reliance; (5) economic loss; and (6) loss causation.[82] Additionally, "[a]n inflated purchase price will not itself constitute or proximately cause the relevant economic loss."[83] The plaintiff cannot suffer a loss at the instant that the transaction takes place since the price of the share at that moment allegedly represents its value.[84] The reselling of shares at a lower price may represent economic circumstances rather than some form of misrepresentation by the company.[85]

Ultimately, the court held that the plaintiff did not sufficiently establish loss causation by merely stating that a misrepresentation led to an inflated purchase price.[86] Unfortunately, *Dura* still leaves considerable room for interpretation. In general, plaintiffs may be able to recover without a drop in stock price, a defendant company may be able to prevent recovery by plaintiffs by disclosing unrelated negative information ahead of the actual fraud, and there is no determination as to whether *Dura* applies to investors involved in multiple transactions.[87] Nonetheless, *Dura* establishes that loss causation is the key element and "gatekeeping mechanism" for private securities fraud claims.[88]

Dura is often credited as an attack on "abusive practices" in securities fraud cases.[89] Plaintiffs continued to bring securities fraud cases to court because they were so expensive to litigate that they were often settled for large sums.[90] This created an incentive to initiate even frivolous lawsuits in the hopes of receiving a settlement.[91] Professor Kaufman argues that, rather

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[82] Id.
[83] Id.
[84] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 338, 125 S.Ct. 1627, 1630-31 (2005). An inconsistency is possible here, in that although market price supposedly represents the value of a security, if fraud already occurred, then we could not say with certainty that the price is an adequate determination of the security's value.
[85] *Id.* at 1632.
[86] Id.
[87] Fisch, Concern: Causation and Federal Securities Fraud at 825.
[88] Id.
[89] Michael J. Kaufman, At a Loss: Congress, The Supreme Court and Causation Under the Federal Securities Laws, 2 N.Y.U. J. L. & BUS. 1, 13 (2005).
[90] Citation needed.
[91] Citation needed.

than create an onerous causation standard, the heightened pleading and sanctions standards of the statute should deter frivolous suits.[92]

Although the Supreme Court attempted to resolve a circuit split in *Dura*, the case left a considerable number of unanswered questions. For instance, the Court did not evaluate whether loss causation must be pled with particularity, as is the requirement for the scienter element.[93] The Court only recognized that a short, plain statement of the loss causation is required.[94] *Dura* also did not address corrective disclosures and what types of disclosures would be sufficient to establish loss causation.[95]

C. Circuit Split

1. Meyer v. Greene (11th Circuit)

In *Meyer*, the plaintiffs, participants in The City of Southfield Fire & Police Retirement System, appealed after the dismissal of their class-action securities fraud complaint again the St. Joe Company and its officers for violating §10(b).[96] St. Joe was a publicly-traded real estate development corporation.[97] Once the market crashed in 2008, the company's holdings declined and it halted many of its projects.[98] The investors claimed that St. Joe failed to disclose the declining value of its assets in its quarterly and annual SEC reports.[99]

On October 13th, 2010, a hedge-fund investor, David Einhorn, made a presentation, which involved a discussion of St. Joe's assets.[100] He claimed the assets were significantly

[92] Michael J. Kaufman, At a Loss: Congress, The Supreme Court and Causation Under the Federal Securities Laws, 2 N.Y.U. J. L. & BUS. 1, 13 (2005).
[93] William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors*, § 13.05 (8th ed. 2011).
[94] Id.
[95] Id.
[96] Meyer v. Greene, 710 F.3d 1189, 1192 (11th Cir. 2013).
[97] Id.
[98] Id.
[99] Id.
[100] Meyer v. Greene, 710 F.3d 1189, 1193 (11th Cir. 2013).

overvalued and that their decrease in value should be disclosed.[101] In the following two days of trading, St. Joe's stock dropped 20%.[102] Accordingly, investors filed a complaint on November 3, 2010, based on the drop in share price.[103] The district court dismissed the complaint for, among other reasons, failing to adequately plead loss causation.[104]

On January 10, 2011, St. Joe's disclosed the initiation of the SEC's informal investigation into the company's impairment of real estate assets.[105] An order of private investigation by the SEC followed on July 1, 2011, regarding federal antifraud securities provisions and reporting requirements.[106] The investors amended the complaint to add these disclosures, but the district court again dismissed.[107] The court found that the plaintiffs failed to allege loss causation since "the Einhorn Presentation was based solely on publicly available information, and the SEC investigations indicated nothing more than a risk of accounting problems."[108]

On January 27, 2012, St. Joe announced that it would declare impairment of between $325 and $375 million in assets for the fourth quarter of 2011.[109] Plaintiffs then amended their complaint to add this information, which resulted in another dismissal.[110] The investors then appealed to the circuit court.[111]

The court determined that the Einhorn Presentation did represent a *corrective disclosure* because it did not disclose any *new* information and was based solely on publicly available

[101] Id.
[102] Id.
[103] Id.
[104] Id.
[105] Id.
[106] Meyer v. Greene, 710 F.3d 1189, 1193 (11th Cir. 2013).
[107] *Id*.
[108] *Id*. at 1193-94.
[109] Meyer v. Greene, 710 F.3d 1189, 1194 (11th Cir. 2013).
[110] Id.
[111] Id.

information.[112] According to *efficient market theory*, the market price of a security reflects all publicly available information.[113] Additionally, "the mere repackaging of already-public information by an analyst or short-seller is simply insufficient to constitute a corrective disclosure."[114] The court also held that the SEC investigations were not enough to sustain a claim of loss causation since the SEC did not issue a finding—or indicate any allegations—of wrongdoing. The court determined that the sole initiation of an SEC investigation does not constitute a corrective disclosure.[115]

2. In Re Bradley Pharmaceuticals (District of New Jersey)

In *Bradley*, the plaintiffs, a class of common stock investors, filed a complaint alleging securities fraud against Bradley, a publicly-traded producer of over-the-counter and prescription pharmaceuticals.[116] The plaintiffs alleged that Bradley made a $1 million "sham" sale of a cold drug, Deconamine, "to artificially inflate Bradley's net income for the Third Quarter of 2004" without any expectation that consumers would keep the product.[117]

Bradley disclosed the earnings from Deconamine in its Third Quarter Press Release on October 28, 2004.[118] On February 28, 2005, the company issued a press release that the SEC was commencing "an informal inquiry relating to the Company to determine whether there have been violations of the federal securities laws."[119] Bradley's stock price then immediately fell 26.4%.[120]

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[112] Meyer v. Greene, 710 F.3d 1189, 1198 (11th Cir. 2013).
[113] *Id.* at 1197(*citing* Thompson v. RelationServe Media, Inc., 610 F.3d 628, 691 (11th Cir. 2010)(Tjoflat, J., concurring in part and dissenting in part)).
[114] *Id.* at 1199.
[115] *Id.* at 1201.
[116] In re Bradley Pharms., Inc. Secs. Litig., 421 F. Supp. 2d 822, 824 (D.N.J. 2006).
[117] Id.
[118] *Id.* at 824-825.
[119] Id.
[120] Id.

The company released a restatement of earnings in April, 2005, which did not result in any substantial change in share price.[121]

The *Bradley* court rejected a "rigid and dogmatic, interpretation of *Dura*" in favor of "pragmatic understanding[.]"[122] The court theorized that the plaintiffs must show that knowledge of the misrepresentation occurred before the drop in share price, but that the Dura opinion did not address "what type of events or disclosures may reveal the truth" or how specific the disclosure must be.[123]

The *Bradley* court highlighted the Supreme Court's statement in *Dura*, that "pleading rules are not meant to impose a great burden upon a plaintiff."[124] In re Bradley Pharms., Inc. Secs. Litig., 421 F. Supp. 2d 822, 829 (D.N.J. 2006)(*quoting* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 348, 125 S.Ct. 1627, 1634 (2005). The court held that, since the investors alleged that Bradley's stock price dropped after the alleged misrepresentations were revealed, this was sufficient to satisfy loss causation. In re Bradley Pharms., Inc. Secs. Litig., 421 F. Supp. 2d 822, 829 (D.N.J. 2006).

3. In Re Gentiva (Eastern District of New York)

Gentiva involved a home health provider that was paid in advance by Medicare via the home health prospective payments system ("HH PPS").[125] The plaintiffs alleged that, in order to increase revenue, "Gentiva's clinicians and managers were pressured by senior executives to provide patients with medically unnecessary visits and services in order to reach the enhanced

[121] Id.
[122] In re Bradley Pharms., Inc. Secs. Litig., 421 F. Supp. 2d 822, 828 (D.N.J. 2006).
[123] *Id*. at 828.
[124] *Id*. at 829)(*quoting* Dura, 125 S.Ct. at 1634).
[125] In re Gentiva Secs. Litig., 932 F. Supp. 2d 352, 359 (E.D.N.Y. 2013).

payment thresholds from Medicare."[126] Gentiva employees effectively provided clients with more services than necessary in order to boost profits.[127]

The plaintiffs' complaint alleged that the company repeatedly represented in SEC filings and other public statements that Gentiva was "in compliance" with Medicare "standards and regulations".[128] The plaintiff identified three "partial disclosures" by Gentiva: (1) announcements of the SFC and SEC investigations; (2) negative earnings releases; and (3) the SFC Report.[129] On May 13, 2010, the Wall Street Journal reported that the Senate Finance Committee began an "investigation into the practices of companies that provide in-home therapy visits reimbursed by Medicare, including Gentiva."[130] Gentiva's stock then sank 7%.[131] On July 1, 2010, the company issued a press release representing its active cooperation with the SFC, but that neither the SFC nor the SEC initiated a formal investigation.[132] The stock then fell 11%.[133] Gentiva disclosed the commencement of the SEC investigation on July 13, 2010.[134] The stock price declined 9%.[135]

The *Gentiva* court rejected the idea that a disclosure of an investigation, standing alone, is not a form of corrective disclosure.[136] The court reasoned that the actual form of the factual allegations of fraudulent conduct is insignificant.[137] "The inherent veracity of the information is the paramount concern and the form that it takes it not as critical."[138]The court found that the announcement of this investigation was enough to establish loss causation. "The announcement of a governmental investigation is the type of non-public new information that was not available

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[126] Id.
[127] Id.
[128] *Id.* at 362.
[129] In re Gentiva Secs. Litig., 932 F. Supp. 2d 352, 385 (E.D.N.Y. 2013).
[130] Id.
[131] Id.
[132] Id.
[133] Id.
[134] Id.
[135] In re Gentiva Secs. Litig., 932 F. Supp. 2d 352, 385 (E.D.N.Y. 2013).
[136] *Id.* at 387-88.
[137] Id.
[138] Id.

to the market, as opposed to something such as reports derived from a company's published financials. The court cannot conclude that this information was already reflected in the price of Gentiva's securities. In line with many district courts to have addressed this issue, the Court finds that the fact that Gentiva's stock price dropped after these announcements belies such a conclusion."[139]The court ultimately dismissed the claim for failure to plead scienter, but this does not affect the court's opinion on loss causation.[140]

III. ANALYSIS OF THE LOOS DECISION

In *Loos*, the court demanded that the market must react to *fraud*, rather than just the "poor financial health" of Immersion Corp. The quarterly reports indicated disappointing earnings, but not necessarily fraudulent accounting practices.[141] The court compared the *Loos* case to *Daou*, where the District Court determined that disappointing earnings were not sufficiently linked to an alleged accounting fraud.[142] The Circuit Court reversed, citing a plausible connection.[143] The court determined that $10 million in unbilled revenue was sufficient.[144] Accordingly, the court determined the amounts and circumstances of Immersion were far less substantial than those in *Daou*.[145] Therefore, the *Loos* court determined that the sufficient link in *Daou* was not apparent in the *Loos* facts.[146] However, the court does not create any reasoning as to why $10M is sufficient but over $3M is not.[147, 148]

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[139] *Id.* at 388.
[140] *Id.* at 389.
[141] Loos, 2014 U.S. App.LEXIS 17813 at *15-16 (*citing* Sparling v. Daou (In re Daou Sys.), 411 F.3d 1006, 1025 (9th Cir. 2005)).
[142] Id.
[143] *Id.* at *16.
[144] Id.
[145] Id.
[146] Id.
[147] *Infra n.30*.
[148] The particularity of the amount of fraud required to sufficiently plead securities fraud under 10b-5 is a question for another article. For instance, should the amount required be objective or subjective based on the total revenues of the company in question?

The court asserted that an outright admission or finding of fraud is not necessary. However, evidence of a "risk" or "potential" for fraud is insufficient.[149] The court pointed out that, when an investigation is announced, it is impossible to know what the investigation will "ultimately reveal."[150] Nonetheless, one could speculate as to the result of an investigation. It is probable that an investigation is announced *because* there is a strong possibility of fraud. Nonetheless, the Court stated that such an announcement only puts investors on notice of *potential* fraudulent conduct.[151] Any decline in share price is then a result of speculation and not whether fraud truly occurred. The court stated that *speculation* should not be the "basis of a viable loss causation theory."[152] This logic is questionable though. If the fraud is likely, then investors can expect share price to decline drastically. If investors are unsure, the price may decline slightly. If the investigation seems to be an unnecessary sham, investors will ignore the disclosure.

A. Implications for Current and Future Investigations and Securities Fraud Claims

Since the circuits are far from consistent on the issue of loss causation, pleading requirements for securities fraud will differ based on the circuit court. *Loos* leaves open the possibility that other disclosures of investigations could be enough to fulfill the loss causation requirement. "So, there could potentially be instances in which the announcement of an investigation occurs in a context different from that in *Loos* and in which plaintiffs press loss

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[149] Loos, 2014 U.S. App. LEXIS 17813 at *18-19.
at 18-19.
[150] *Id*. at 23.
[151] Id.
[152] Id.

causation arguments arising from the announcement of an investigation."[153] The holding in *Loos* does not qualify what types of investigations are sufficient to establish loss causation. The holding is specific to the facts of *Loos* and leaves open the possibility that investigations with a stronger inference of fraud (whatever the requisite level required to establish a stronger inference may be) could fulfill loss causation.

In a recent Fifth Circuit case, *Amedisys*, the court held that *multiple* disclosures are sufficient to establish loss causation.[154] Amedisys, a publicly traded health services corporation, provided unnecessary medical visits in order to receive Medicare reimbursement.[155] The plaintiffs alleged that Amedisys revealed the fraud through five "partial" disclosures including (1) an analyst's report on the fraud; (2) the resignation of two Amedisys executives; (3) a *Wall Street Journal* article regarding the fraud; (4) disclosure of government investigations; (5) poor quarterly earnings.[156] The stock later declined by 60 percent.[157] Although Amedisys argued that none of these disclosures, standing alone, would be sufficient to establish loss causation, the court held that the *totality* of these disclosures fulfilled loss causation.[158]

Professor Kaufman argues that the intentions of the PSLRA are often misinterpreted.[159] The *causation* required for a securities fraud claim in fraud-on-the-market cases is not of the kind adopted in *Dura*.[160] The plaintiff is not required to prove that the defendant's caused any

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[153] Peter Stone, Joshua Hamilton, et. al., *Paul Hastings Discusses Ninth Circuit's Decision on Loss Causation*, THE CLS BLUE SKY BLOG (Oct. 9, 2014, 8:26 AM), http://clsbluesky.law.columbia.edu/2014/09/09/paul-hastings-discusses-ninth-circuits-decision-on-loss-causation/.
[154] William M. Regan & Ashley H. Jones, *Fifth Circuit Holds Multiple Disclosures Establish Loss Causation in Securities Action*, THE NATIONAL LAW REVIEW (Oct. 10, 2014), http://www.natlawreview.com/article/fifth-circuit-holds-multiple-disclosures-establish-loss-causation-securities-action (*citing* Public Emps. Ret. Sys. of Miss. v. Amedisys, Inc., No. 13-30580 (5th Cir. Oct. 2, 2014).
[155] Id.
[156] Id.
[157] *Id*.
[158] *Id*.
[159] Michael J. Kaufman, At a Loss: Congress, The Supreme Court and Causation Under the Federal Securities Laws, 2 N.Y.U. J. L. & BUS. 1, 9-10 (2005).
[160] Id.

decline in the price of the stock, but that the defendant's misrepresentation created a disparity or artificiality between the price of the stock and its actual value.[161] This intention is memorialized by the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs on May 17, 1994.[162]

B. Implications for Corporations

Due to the *Loos* decision, we now must figure out "*when* a company should announce the commencement of an internal investigation and *what* information should the announcement include."[163] Since the announcement of an investigation, standing alone, will not be enough to establish a securities fraud claim, directors are not disincentivized to prevent disclosure. One could argue that this is a benefit to shareholders, because companies are not deterred from disclosing investigations, which may be pertinent to shareholders' investment decisions.

The *Loos* holding creates greater incentive for companies to announce investigations, since they will not automatically be subject to securities fraud suits. This allows for more transparency in the marketplace. Shareholders will be informed of occurrences within the company.

By the same logic, though, one could argue that these announcements verify the fraud-on-the-market cause of action as legitimate, since the stock price will reflect all the public information on the company. Courts may be splitting hairs by arguing that an announcement of an investigation correlated with a dip in stock price does not inevitably assume the existence of fraud. In reality, investors may be under the assumption that fraud either did occur or is a significant enough possibility that an investment in the company is considered too risky.

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[161] Id.

[162] *Id.* (*citing* Abandonment of the private right of action for aiding and abetting securities fraud/staff report on private securities litigation: Hearing before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, 103rd Cong. 228 (1994) (printed for the use of the committee on Banking, Housing, and Urban Affairs)).

[163] Peter Stone, Joshua Hamilton, et. al., *Paul Hastings Discusses Ninth Circuit's Decision on Loss Causation*, THE CLS BLUE SKY BLOG (Oct. 9, 2014, 8:26 AM), http://clsbluesky.law.columbia.edu/2014/09/09/paul-hastings-discusses-ninth-circuits-decision-on-loss-causation/.

In any case, companies can manipulate their disclosures in order to prevent securities fraud litigation. Before disclosing an event that could be considered fraud, corporate officials may disclose unrelated negative information that reduces the stock price.[164] Known as "walking down the stock price," this behavior prevents the shareholder from being able to point to the alleged fraud as the cause of the stock price decline.[165] The corporation may also release positive news at the same time as the possibility fraudulent news, in order to offset the likelihood of a stock dip.[166] Another technique is for the company to wait until market issues result in a stock price fall and only then disclose the fraudulent conduct.[167] These examples show that a corporation can use numerous techniques and devices to prevent a plaintiff from being able to sufficiently plead securities fraud.

C. Implications for future Cases

The *Loos* case is decided merely at the pleading stage. Would it be more equitable to allow the claim to continue to discovery in order to find out whether fraud actually occurred? If we allow the claim to proceed, the effect of the ruling would essentially create another investigation alongside the internal, consulted, or SEC (or other agency) investigation. Is it necessary to have two investigations of a company this early in the process? Could this cause more problems for the company and its shareholders than the alleged fraud actually merits?

The solution is to decide which allegations of fraud warrant further discovery and which are so attenuated as to be inadmissible at the pleading stage. The *Loos* court determined that the facts of Immersion's situation were insufficient to allow the case to continue.

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164 Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 852 (2009).
165 *Id*.
166 Id.
167 Id.

There are still a significant number of questions that must be answered before evaluating the *Loos* decision: How often are investigations conducted on businesses? How often do these investigations reveal fraud? What proportion of securities fraud goes undetected (probably impossible to determine)? How reluctant are companies to initiate an internal investigation? (If they are very reluctant (and I would assume they probably are), then the disclosure of an investigation should be strong evidence of underlying fraud.)

If we terminate a claim at the pleading stage, this may give more time for the company to cover up the fraud or articulate what occurred in a different fashion in order to not scare off investors. The average time between a misstatement of fact and the truth being revealed to the market is 10.5 months.[168] This also makes determining the amount of harm difficult, since there are many factors that could affect the stock price during this extended period.[169]

If the announcement of an investigation is likely the result of some form of fraud, it may make sense to allow the case to proceed. Court-ordered discovery would create a check on the internal investigation.

Regarding the announcement of an investigation: "Everyone and their mother knows exactly what that means … [t]here was an investigation *because* there was fraud … [t]hat's why the stock price tanks. Because if an investigation was 'just an investigation,' no one would care, right? But they do. Know why? Because people with money on the line are much, much, much smarter than people in black robes who might say 'Oh, it's only an investigation, no actual fraud.'"[170] Professor Martin argues that a more appropriate rule would be to look at the

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[168] Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 849 (2009).
[169] Id.
[170] Shaun Martin, *Loos v. Immersion Corp*, CALIFORNIA APPELLATE REPORT (Oct. 9, 2014, 9:05 PM), http://calapp.blogspot.com/2014/08/loos-v-immersion-corp-9th-cir-aug-7-2014.html.

stock price in the long term.[171] If the stock drops after announcement of an investigation and continues to stay low, there is evidence of loss causation.[172] If the stock drops initially, but then ultimately rebounds, there is no loss causation.[173]

Some scholars argue that one disclosure is only considered to be inaccurate after a later disclosure modifies or falsifies the previous one.[174] This view assumes that investors only see disclosed information as either true or false and are therefore speculating until a later disclosure proves their hypothesis.[175] However, in reality, investors take a more nuanced approach and make an inference based on all the information they have gathered.[176] Investors then decided whether these facts influence the value of the company's securities.[177]

Perhaps the trier-of-fact should be responsible for deciding whether a loss is the result of the disclosure of fraud.[178] It may be inequitable to have a court decide how a reasonable investor would behave while facing the same investment decision.

Defending securities fraud is extremely expensive and often results in settlements to prevent a legal war of attrition from occurring.[179] The benefit of the *Loos* decision to companies is that they will not incur substantial legal fees unless there is considerable evidence of fraud.[180] The *Loos* decision may also be a reaction to the threat of frivolous suits by securities fraud litigators.[181]

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[171] *Id*.
[172] Id.
[173] Id.
[174] *Ninth Circuit Misconstrues Loss Causation Requirement in Loos v. Immersion Corp.*, SECURITIES DIARY (Oct. 9, 2014, 7:10 PM), http://securitiesdiary.com/2014/09/16/ninth-circuit-misconstrues-loss-causation-requirement-in-loos-v-immersion-corp/.
[175] Id.
[176] Id.
[177] Id.
[178] Id.
[179] Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 818-19 (2009).
[180] Id.
[181] Id.

Since *Loos* seems to be fact-sensitive, what types of announcements revealing an internal investigation *are* sufficient to establish loss causation?

There is, at least, one positive aspect of the *Loos* decision: cases will not be brought until an investigation is complete. This will prevent early, speculative cases from flooding the courts until they are ripe with evidence of securities fraud. The decision falls in line with the classic presumption that litigation should not overwhelm the court system. *Loos* acts as a gatekeeper for securities fraud cases in the embryonic stage. But this standard may cause corporations to wage a war of attrition by extending investigations as long as possible. *Loos* goes too far and adds a requirement that prevents some securities fraud claims by plaintiffs who should be able to get past the pleading stage.

IV. CONCLUSION

The Ninth Circuit's interpretation of loss causation is difficult to fulfill and likely inappropriate given the legislative history of the PSLRA. The Ninth Circuit, as well as other federal courts, has strong reasons for requiring hardline loss causation standards. The abuse of the securities fraud claim prior to the PSLRA cost corporations millions of dollars in legal fees. In order to prevent these frivolous suits, the legislature sought stricter requirements at the pleading stage. Nonetheless, the Ninth Circuit and others have gone to far in their analysis of the loss causation element. The purpose of loss causation is to show that a disclosure caused a *disparity* between the stock price and the stock value. The analysis ends there. In *Loos*, the plaintiff should be able to pass the pleading stage by showing that the corrective disclosures revealed a difference in the stock price and the stock value. This should not be a difficult requirement to overcome, given that Immersion Corp. falsified their revenue and did not uphold GAAP. As the Supreme Court stated in *Dura*, "It should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind."[182]

The decision in *Loos* is incorrect in that it is naïve to assume that the "market cannot possibly know what the investigation will ultimately reveal."[183] If an investigation is necessary, then there is a strong assumption by investors that the value of the stock will decrease. As the *Gentiva* court correctly asserted, the actual form of the factual allegations of fraudulent conduct is insignificant.[184] It is the *significance* of the disclosure that is relevant. This is, of course, relative to the impact of the investigation and the proportion of the corporation's business it affects. In a relatively small corporation like Immersion Corp., improper accounting practices can have an enormous effect on the value of the shares. We assume that market price adequately reflects what investors perceive the value of the corporation to be. If that is so, then the fact that an investigation is announced and the stock price dips should be enough to allow plaintiffs to allege loss causation in a securities fraud claim at the pleading stage.

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182 544 U.S. at 347.
183 Loos citation.
184 In re Gentiva Secs. Litig., 932 F. Supp. 2d 352, 387-88 (E.D.N.Y. 2013).