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- **Securities Class Actions**
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 - **Battling Banks**

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Special Convention Preview || 40

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Beware of Dog || BY VANESSA B. CANTLEY AND MEGAN R. U'SELLIS || 42

Dog bite cases have taken on new meaning in light of laws that regulate "inherently dangerous" breeds. Here's what you need to know.

Shedding Light on Peer Review Privilege ||

BY PAUL A. CASI II AND KEVIN C. BURKE || 50

Medical peer review procedures examine whether a physician met applicable medical standards, yet discovery of peer review information is often limited by law. Disclosure of this valuable data can be achieved—but only if you know how to ask for it.

14

WEATHERING THE STORM OF CAUSATION CLAUSES

Natural disasters can overwhelm homeowners with wind, rain, floods—and frustration. Insurers use anti-concurrent causation clauses to sandbag their liability, but there are tools at your disposal to protect your clients.

BY JEFFREY L. RAIZNER, ANDREW P. SLANIA, AND AMY B. HARGIS

20 When Disaster Strikes, Know the Drill

By Brian D. Katz, Soren Gisleson, and Joseph E. Cain

22

BATTLE WITH THE BANKS

Banks are big business, and so are the challenges when you take them on in a consumer fraud lawsuit. Your success depends on surmounting four common obstacles.

BY RICHARD GOLOMB AND TAMMI MARKOWITZ

28

CALCULATING DAMAGES IN SECURITIES CLASS ACTIONS

Scratching your head over loss causation and damages? Knowledge of a few basic concepts will help you navigate these issues in your securities class action.

BY ADAM J. LEVITT AND THOMAS H. BURT

34

CYBER PIRATES

BitTorrent technology is the tool of the modern-day pirate, and it has resulted in the global pillaging of copyrighted materials. This cyber menace requires an equally sophisticated approach by plaintiff lawyers.

BY PAUL LESKO

CALCULATING

DAM



Proving damages can seem daunting in a class action that alleges investors bought securities based on a company's misrepresentations. But if you learn some basic concepts, you can understand how to help your clients recoup some of their losses.

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IN SECURITIES CLASS ACTIONS

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To lawyers unfamiliar with the process, establishing damages in a securities class action case may appear inscrutable, a sort of wizardry conducted by an expert witness. But the reality is far from that. Although the process has its complexities, some basic information can help you understand the process and the challenges you might face representing your clients in securities cases.

The three most common claims in securities class action litigation arise under section 11 of the Securities Act of 1933 (misstatement in a registration statement), section 12 of the Exchange Act (misstatement in a prospectus), and section 10(b) of the Exchange Act (deceptive or misleading scheme in the sale of listed securities). Damages in section 11 and section 12 claims are statute based, so they can be readily understood by reading the statute.

Damages for section 11 violations are the difference between the offering price and the price at which class members sold or held the security in question. Calculating those damages for any class member is typically straightforward.¹ Likewise, section 12 claims, which arise from a purchase on a prospectus, offer rescissionary damages in the amount of the purchase price, less any income received by sale, dividend, interest, or otherwise—another relatively straightforward

calculation. Only cases under section 10(b) of the Exchange Act regularly present a more complicated damages framework, both in concept and application.

The generally accepted measure of damages in section 10(b) cases is out-of-pocket damages. In simplest terms, that means that damages are based on the difference between the plaintiff's purchase price and the fair value of what the plaintiff purchased. This amount is typically referred to as "inflation." This disparity

can be summarized by explaining the Supreme Court's holding in *Dura*. With a liquid security that investors purchased at an artificially inflated price, the investors have not yet suffered a loss because they can sell at the same price and recapture the amount by which they were cheated. Obviously, this framework applies only to a security that can be readily resold at the same price, which is typical of securities susceptible to class litigation treatment.

fool investors into paying too much, the truth comes out, and the security's market price drops.⁴ In that situation, the transaction causation—the buy at the inflated price—happens at purchase, but when the price drops without the investor recapturing the inflation, that loss completes the cycle.⁵

A closely related securities damages theory, "materialization of the concealed risk," is commonly accepted as well. Under this theory, the company conceals material information that would have been reflected in the market price, such as the probability that a key product will not receive regulatory approval. As to other possible theories, the law is relatively undeveloped.

IN
THE SECURITIES LITIGATION
DAMAGES CONTEXT, THE INFLATION
CONCEPT IS STRAIGHTFORWARD
IN THEORY. IN PRACTICE,
HOWEVER, IT IS COMPLICATED BY
REAL-WORLD ISSUES.



Inflation and the ‘Damages Ribbon’

In the securities litigation damages context, the inflation concept is straightforward in theory, and it is simple if you have a fact pattern with a single announcement from the company. For example, if the price of a security hovered at about \$20 while the company concealed a host of bad news, and then dropped rapidly to \$2 when the facts became impossible to hide, the inflation is basically \$18—what each class member paid minus the amount the security would be worth sold after the disclosure—subject to a statutory cap. The Private Securities Litigation Reform Act of 1995 caps this measure at the difference between the purchase price and the trading average of the security in the 90 days after the drop.⁶

In practice, however, this straightforward approach is complicated by two real-world issues. Many cases involve multiple false statements and multiple disclosures of bad news. The multiple statements cause the inflation in the stock or bond price to fluctuate over time. Moreover, the entirety of the inflation may not be directly related to the

in value, even if it reflects inflation and even if the investor is defrauded, does not constitute damages until the investor suffers a “cognizable loss”—a loss that is compensable under the current loss causation jurisprudence, as set forth in *Dura Pharmaceuticals, Inc. v. Broudo* and its progeny.²

Loss causation and damages in securities cases are separate issues, but they are so closely related that they can never be entirely disentangled. Loss causation

Based on that fact, *Dura* held that there is one superficially attractive theory of loss causation that, without more, is insufficient: that at the time of purchase, the investor was misled and paid too high a price for the security. This is sometimes called “purchase-time value disparity.”³ The Court also said that another theory—often called “drop on disclosure”—always suffices. Under that theory, the company makes misrepresentations or omissions that

stock price. Indeed, the stock price can move for reasons not related to any misstatement, as sometimes the price goes up or down because of things that affect the whole market or the company's industry. Also, the amount of inflation can change, usually increase, without a change in the securities price. The most obvious example is when the company suffers further reversals of fortune but conceals them, thereby increasing the inflation of its stock price without disclosing to the market any material information that would move the price. Only those changes in inflation that meet the standard of loss causation can serve as the basis for the damages calculation.

Inflation fluctuations of a particular security produce what is often called a "damages ribbon" of varying width.⁷ The damages ribbon runs the length of the class period and widens as inflation increases and narrows as it decreases. Every time the amount of inflation changes, the damages ribbon gets wider or narrower. Every time the damages ribbon narrows, investors who purchased when the price was more inflated and sold when it was less inflated are damaged.

Suppose a company says it has a new contract with the French government and estimates the potential positive impact on the company's bottom line. Also suppose that the statement is false and that its inflationary effect is \$5 per share. One month later, the company falsely represents that it has a contract with Belgium as well—a statement that inflates its stock price by another \$2 per share, widening the ribbon to \$7 per share. If the company, one month later, discloses that the France contract fell through and the security falls \$5 per share with that revelation, then \$2 of inflation still remains in the stock by virtue of the Belgium contract, until it is subsequently revealed to be nonexistent.

In that situation, the loss for which the class members are entitled to be

compensated is the difference between the inflation when they purchased and the inflation when they sold. A purchaser who bought before the France misstatement and held through the France curative disclosure would be entitled to nothing because the purchaser bought at zero inflation. A purchaser who bought after the France misstatement and sold after the France revelation would be due \$5 per share.

Purchasers who bought after the Belgium announcement but sold after the France curative disclosure would still be due only \$5 per share because, at that point, they have not yet suffered a loss from the Belgium misstatement—unless an expert can show that the market assumed the Belgium announcement was also false and priced that in, which is conceivable.

Some drops in securities prices are not related to misstatements and do not affect inflation. Suppose our company has recently announced the fictitious Belgium contract when its major competitor releases a product that appears positioned to kill its coming year sales. If the price of the security falls by \$12, how much are the investors damaged? Zero. They have losses, but they are investment losses caused by the competitor's

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news, not by our company's fraud. Further complicating this analysis is that companies often—and in many plaintiff lawyers' view, deliberately—announce a mix of bad news that is unrelated to prior false statements along with related news, resulting in disclosures like: "We're revising next year's sales down by 50 percent because our competitor's new product does things we still can't do, and by the way, the France and Belgium contracts we previously announced are no longer valid." This sort of amalgamated disclosure is meant to confuse the causation analysis enough for a company to evade liability.⁸

Nuts and Bolts

For class certification, the plaintiffs' expert generally will conduct an event study, identifying significant pieces of

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news from financial press and analyst coverage and examining their impact on the market. Experts screen out broader market movements using an appropriate big index like the NASDAQ or the S&P 500, and they factor in industry or sector movements using either a custom-built index of the company's competitors or a preexisting one.⁹

Next, experts evaluate the company's individual actions, as measured by a statistical confidence interval (the certainty that an observation reflects reality and not just random noise in the data). The interval is often 95 percent. The expert then must explain the movements that are company-specific and not random noise. Upward movements are either inflation going into the price or are unrelated to the alleged fraud. Downward movements are either inflation leaving or are unrelated to the fraud.

Many misleading statements are not susceptible to a measurement of their inflationary impact at the time they were made. For example, a statement that "product development is moving along with no major hurdles" will not tell the market anything new, but if the product in question has run off the rails in testing, then the statement's inflationary impact could be huge: The price may stay where it is, when the market would have cut it by 60 percent if the reality had been disclosed. So the market's reaction to the revelation is generally the standard. Using our exemplar company once again, if the drop on disclosure that the France deal fell through was \$5, then the inflationary effect of the fake contract was \$5.

The hardest part is when multiple disclosures coincide, with some unrelated to the fraud. To use any drop at the time of disclosure to measure the impact of earlier false statements, and to recover for the loss, the expert will have to distinguish the fraud-related conduct from the unrelated news. The expert does this

either by starting with the whole and putting a proportion or price tag on the unrelated pieces of news, leaving only the inflationary parts, or by finding a way other than the market price reaction to value the fraud-related bad news, such as by estimating an earnings-per-share impact of the fraud-related events.

Finally, applying the calculations to each class member is not an issue for trial. That's what the claims process is for. Aggregate numbers often are inadmissible at trial because they are estimates based on trading models, the assumptions for which are reasonable but hard to test empirically.¹⁰ So the trial establishes the elements, including the damages ribbon, and then the class members' actual transactions supply the data for per-member calculations. It is well established that the mechanical complexity of applying the calculation does not affect class treatment.¹¹

Damages issues in securities class actions can be complex, but if you have a good understanding of the factors that go into proving the damages, you'll be able to help your clients recover the losses they suffered because of a company's fraud. 



Adam J. Levitt is a partner at Grant & Eisenhofer in

Chicago and can be reached at alevitt@gelaw.com. **Thomas H. Burt** is a partner at Wolf Haldenstein Adler Freeman & Herz in New York City and can be reached at burt@whafh.com.

NOTES

1. The exception is when the allegations encompass a panoply of offerings at different prices—a relatively rare occurrence.
2. 544 U.S. 336 (2005).
3. *Id.* at 342 ("Normally, in cases such as this one (i.e., fraud-on-the-market cases), an inflated purchase price will not itself

constitute or proximately cause the relevant economic loss. . . . [A]t the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value.").

4. *Id.* at 344 (quoting *Restatement (Second) of Torts* §548A, cmt. b, at 107, and stating with approval, "[T]he *Restatement of Torts*, in setting forth the judicial consensus, says that a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains 'when the facts . . . become generally known' and 'as a result' share value 'depreciate[s].'" Incorporated within this theory of loss causation is a presumption of reliance where fraud was committed against the public as a whole (the fraud-on-the-market presumption). In *Amgen, Inc. v. Connecticut Retirement Funds & Trust Funds* (133 S. Ct. 1184, 1191 (2013)), a 6-3 Court rejected requiring proof of materiality or allowing rebuttal of the fraud-on-the-market presumption at the certification stage, which means, in practice, that the *Amgen* decision has little practical effect.
5. *Dura Pharms., Inc.*, 544 U.S. at 344.
6. 15 U.S.C. §78u-4(e)(1) (2010).
7. For purposes of this exemplar, we're treating stocks, bonds, and options as equivalent.
8. In a classic opinion concerning causation, albeit in a non-securities context, Judge Richard Posner discussed how the plaintiffs "forewent the opportunity to prove a smaller loss but one recoverable under the law of damages, which was not drafted by Santa Claus.") *Movitz v. First Natl. Bank of Chi.*, 148 F.3d 760, 765 (7th Cir. 1998).
9. This facet of the analysis, which is really more art than science, usually involves predicting the defendants' attacks and prospectively countering them.
10. See e.g. *In re Broadcom Corp. Secs. Litig.*, 2005 WL 1403756 at *1 (C.D. Cal. June 3, 2005) (collecting cases in favor of and against consideration of aggregate damages and finding that the aggregate damages calculation was insufficiently reliable).
11. *Fogarazzo v. Lehman Bros.*, 263 F.R.D. 90, 109 (S.D.N.Y. 2009) ("Although each class member's calculation of damages is an individualized inquiry, courts have held that so long as a formula for calculating damages is proposed, 'the fact that damages must be calculated on an individual basis is no impediment to class certification'" (citing *Klay v. Humana, Inc.*, 382 F.3d 1241, 1259-60 (11th Cir. 2004)).)