

February 16, 2010

Fifth Circuit Continues Rigorous Scrutiny of Securities Fraud Class Actions; Denies Class Certification and Tightens Loss Causation Standards

Over the past decade, the Court of Appeals for the Fifth Circuit has set a high bar for securities fraud class action plaintiffs, denying class certification in a number of cases. But in light of the financial crisis and language in recent Fifth Circuit decisions, some may have thought that the tide might be turning. On February 12, 2010, the Fifth Circuit dispelled that notion in [The Archdiocese of Milwaukee Supporting Fund v. Halliburton](#).

The *Halliburton* decision concerned what plaintiffs must prove to demonstrate “loss causation,” which the Fifth Circuit has held is a prerequisite to certifying a securities fraud class action. The decision clarified key principles limiting plaintiffs’ recoverable losses to those stock price declines that are proximately caused by the defendants’ alleged misstatements. In applying those principles to estimates and forward-looking predictions, *Halliburton* also rejects efforts to recover stock price declines occurring merely because those estimates were later revised based on changing business conditions. The decision signals that loss causation will continue to be an issue defendants can successfully challenge to obtain early dismissal, denial of class certification, or summary judgment.

Background

The plaintiff in *Halliburton* claimed that defendants made false statements about three topics: (1) Halliburton’s estimates of potential liability in asbestos litigation, (2) Halliburton’s accounting for revenue in its engineering and construction business, and (3) the benefits to Halliburton of a merger. As in nearly all securities fraud class actions, the plaintiff claimed that it (and a class of shareholders that it sought to represent) bought stock at prices that were artificially inflated by these alleged misrepresentations and suffered losses when the “truth” was revealed and the stock price declined. The district court held that the plaintiff failed to prove that the stock price declines in question were caused by the revelation of the alleged “truth” as opposed to other negative information. Under Fifth Circuit precedent, a plaintiff must prove this causal connection between misrepresentation and loss – referred to as loss causation – before a court can certify a class. The district court therefore denied class certification, and plaintiff appealed.

Fifth Circuit Opinion

On appeal, the Fifth Circuit affirmed the denial of class certification, holding that the district court had applied the correct legal standard for loss causation and that plaintiff had failed to meet its burden of proving loss causation by a preponderance of the evidence. The Fifth Circuit’s opinion clarified and reaffirmed key loss causation principles:

Clarification of the legal standard for loss causation. It is well established that loss causation is not fulfilled by the mere release of any negative information; it requires the revelation of the “truth.” Whether a particular piece of negative information is sufficiently related to an earlier alleged misstatement to be considered the “truth” is often hotly disputed. While recent Fifth Circuit decisions have been less than clear on this issue, the *Halliburton* opinion provides a clear articulation of the standard: “A subsequent disclosure that does not correct and reveal the truth of the previously misleading statement is insufficient to establish loss causation.” Plaintiffs must therefore prove that the disclosure they claim is corrective “shows the misleading or deceptive nature of the prior positive statements.”

Loss causation with respect to estimates and predictions. When companies lower their earnings guidance or revise other estimates, plaintiffs often argue that the revision reveals that the earlier guidance or estimate was untrue. The *Halliburton* court rejected this argument in the context of changes to reserves for asbestos litigation, noting that “[j]ust as merely lowering earnings estimates does not reveal that a defendant previously misrepresented those estimates, merely raising the asbestos reserves does not show that those prior reserve estimates were intentionally

misleading.” The court declared that “a company is allowed to be proven wrong in its estimates,” noting that such estimates may be revised due to non-fraud factors such as subsequent events. Plaintiffs therefore will not be able to prove loss causation as to allegedly false earnings guidance by showing only that the earnings guidance was subsequently revised downward.

Negative information must be new to support loss causation. The Fifth Circuit also reaffirmed that plaintiffs cannot pick and choose purported “truth” revelations merely to take advantage of the largest stock price drop. The Fifth Circuit has previously recognized that information already known to the market – referred to as “confirmatory” information – does not affect the stock price because the market is presumed to have digested all new information quickly and efficiently in a “fraud on the market” case. The *Halliburton* court applied this principle in the loss causation context, holding that the announcement of certain accounting charges and changes in reserves could not constitute a truth revelation for loss causation purposes where that information had previously been announced.

Plaintiffs’ experts must analyze and differentiate the impact of multiple pieces of negative news. As described above, plaintiffs must prove that their economic losses were caused by the revelation of the alleged “truth” as opposed to other negative information that is unrelated to the alleged fraud. A natural corollary is that when multiple pieces of negative news are announced contemporaneously, plaintiffs’ expert must differentiate between the price impact associated with each piece of news. The *Halliburton* opinion, like other Fifth Circuit opinions before it, found the failure of an expert to perform any statistical or econometrical analyses of different pieces of negative information announced in the same press release to be fatal to the plaintiffs’ effort to prove loss causation.

Conclusion

The *Halliburton* decision makes clear that the Fifth Circuit is not backing away from its rigorous scrutiny of whether securities fraud cases are appropriate for class treatment. Of equal importance, the opinion’s clarifications and reaffirmations of the correct legal standards should permit parties and district courts to address loss causation issues without any cloud of uncertainty that may have been suggested by other recent decisions. Challenges to loss causation remain a strong weapon in the arsenal of defendants in securities class actions.

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