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Expert Analysis

When Plaintiffs Overreach: Attacking Flawed Evidence of Loss Causation and Damages in Securities Class Actions

Part 1

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The complexity of proving loss causation and calculating damages in securities fraud class actions presents plaintiffs with an often irresistible opportunity to overstate their losses. Plaintiffs can cloak unrealistic analyses in the veil of science provided by expert testimony, making it difficult for a judge or jury to separate fact from fiction.

But courts have demonstrated both a growing ability to see through these tactics and a better understanding of the basic principles of finance and economics that underlie loss causation. As a result, defendants now are better positioned to use plaintiffs' flawed calculations to defendants' advantage when seeking summary judgment, opposing class certification or moving to exclude plaintiffs' experts.

Plaintiffs can cloak unrealistic loss analyses in the veil of science provided by expert testimony.

To address plaintiffs' evidence of loss causation and damages, it is first necessary to understand how plaintiffs generally distort this evidence. Their method essentially involves a three-step process.

First, plaintiffs "over-identify" corrective disclosures, thus increasing the number of days for which they seek to recover for stock price declines.

Second, plaintiffs fail to account for confounding information released on these days, thus capturing in their damages calculations stock price declines unrelated to the alleged fraud.

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Third, plaintiffs use untested and unreliable statistical models to calculate the total number of damaged shares, thus producing an inflated aggregate damages estimate.

When combined, these three steps result in a substantial overstatement of damages. But courts have begun to take a firm stand against these tactics, and armed with this precedent, defendants can use plaintiffs' overreaching to gain an advantage.

By inflating their losses, plaintiffs provide defendants with a valuable opportunity to exclude plaintiffs' loss causation and damages evidence and open the door for defendants to prevail on summary judgment.

This article is the first in a two-part series and will focus on the strategies plaintiffs employ in steps one (over-identifying corrective disclosures) and two (failing to account for confounding information).

A forthcoming article will address step three and closely examine plaintiffs' use of aggregate damages models, the courts' reluctance to accept them, ways to attack such models under *Daubert v. Merrell Dow Pharmaceuticals Inc.*, 509 U.S. 579 (1993), and the more reliable and practical alternative of limiting the jury's verdict to per-claim damages.

'Over-Identifying' Corrective Disclosures

The Supreme Court's decision in *Dura Pharmaceuticals v. Broudo*¹ generally was considered a win for the defense bar, but the court's narrow holding left an important opening for plaintiffs to exploit. While *Dura* reinforced the fact that the only relevant loss to shareholders in a securities fraud case is the price drop after a corrective disclosure, *Dura* failed to define the precise contours of such a disclosure.

Plaintiffs have responded by alleging that a variety of events can qualify as corrective, regardless of whether new facts about the fraud are revealed. This effort to "over-identify" corrective disclosures is motivated by a single goal: to lay the groundwork for inflated damages estimates.

Plaintiffs generally allege a "trickle out" theory of loss causation, whereby they claim that the fraud was revealed gradually over the course of several weeks or months. By classifying a litany of corporate announcements, analyst reports, public filings, executive resignations and news reports of recent developments at the company as corrective, plaintiffs seek to recover for the price declines associated with each of these disclo-

tures, even if those disclosures revealed no new facts about the alleged fraud.

After *Dura* this tactic met with some success as courts initially seemed reluctant to find any alleged disclosure noncorrective at either the pleading or summary judgment phase.²

But defendants have been increasingly successful at convincing courts to be more vigilant in ensuring that the disclosures plaintiffs identify are in fact corrective.

A recent example of this success is *In re Williams Securities Litigation*,³ where the 10th U.S. Circuit Court of Appeals affirmed the exclusion of plaintiffs' loss causation and damages evidence and the resulting summary judgment in favor of defendants.

In *Williams* the plaintiffs' expert offered two theories of loss causation.

The first was a "leakage theory" that posited a gradual exposure of the fraud over the course of the class period.⁴ To support this theory the expert did not identify specific corrective disclosures but instead included in his report a 1,300-page compendium of news articles, reports and Securities and Exchange Commission filings.⁵

The second theory was a more conventional loss causation analysis in which the expert identified four allegedly corrective disclosures:

- The release of the company's financial statements would be delayed;
- The company was informed that it might be in default under its credit arrangements;
- The company was considering bankruptcy; and
- The company had filed bankruptcy.⁶

The court rejected both theories.

It rejected the plaintiffs' "leakage theory" because their expert's analysis failed to show "some mechanism for how the truth was revealed."⁷

"A plaintiff cannot simply state that the market had learned the truth by a certain date and, because the learning was a gradual process, attribute all prior losses to the revelation of the fraud," the 10th Circuit wrote. "The inability to point to a single corrective disclosure does not relieve the plaintiff of showing how the truth was revealed."⁸

The plaintiffs' argument that their losses were caused by the "materialization of the concealed risk" also did not relieve them of the burden of identifying the point at which that risk "did materialize."⁹

Despite noting that *Dura* did not establish a strict rule requiring a corrective disclosure, the court nonetheless held that plaintiffs must identify when the fraud was revealed or the allegedly concealed risk materialized.¹⁰ From a practical standpoint, it is difficult to imagine plaintiffs meeting this burden without identifying specific corrective disclosures.

The court's holding in this regard is especially important given that the "leakage theory" can greatly inflate plaintiffs' damages estimate. By eliminating the need to identify corrective disclosure dates, the theory allows plaintiffs to seek recovery for long-term stock price declines, essentially providing the "broad insurance against market losses" rejected by *Dura*.¹¹

Courts in the last 10 years have been more willing to scrutinize damages calculations based on a growing understanding of economic and financial principles.

The *Williams* plaintiffs, for example, sought to recover the entire decline in the company's stock price over the year-and-a-half class period — a decline from \$28.50 to \$1.63.¹² Although the court affirmatively rejected the theory, other plaintiffs will no doubt continue to argue its legitimacy.

Likely anticipating the court's rejection of the "leakage theory," the *Williams* plaintiffs' alternative theory of loss causation was based on four allegedly corrective disclosures.

After examining each of these disclosures, however, the court concluded that they were "not supported by a showing of material, new, company-specific and fraud-related information."¹³ Without such a showing, a disclosure could not "be considered 'corrective' such that corresponding losses could be reliably attributed to the revelation of fraud rather than other factors."¹⁴

In essence, the court firmly rejected the idea that "any negative information" about the company can qualify as corrective.

For example, the plaintiffs argued that the announcement of the company's bankruptcy was corrective because bankruptcy was within the "zone of risk" concealed by the earlier misrepresentations.¹⁵ The court rejected this contention, finding that the "causal connection between false statements about a company's prospects and that same company's eventual bankruptcy years later is too remote to constitute a corrective disclosure."¹⁶

Defendants found similar success in *In re Omnicom Group Inc. Securities Litigation*,¹⁷ where, again at the summary judgment stage, the court adopted an appropriately rigorous standard for assessing corrective disclosures.

To establish loss causation the plaintiffs alleged that Omnicom's stock price declined significantly following:

- The public announcement of a director's resignation; and
- A series of negative newspaper articles offering commentary on a questionable transaction.

The defendants sought summary judgment on the plaintiffs' securities fraud claims, arguing, among other things, that these events did not qualify as corrective because they did not reveal any new facts about the alleged fraud.

After acknowledging that "*Dura* does not require that a corrective disclosure 'take a particular form or be of a particular quality,'" the *Omnicom* court nonetheless found that corrective disclosures must satisfy two general criteria.¹⁸

First, "[w]hile a corrective disclosure need not reflect every detail of an alleged fraud, it must reveal some aspect of it," the court said.¹⁹

Second, "the disclosed fact must be new to the market" because a "recharacterization of previously disclosed facts cannot qualify as a corrective disclosure."²⁰

The court applied these criteria to the plaintiffs' alleged corrective disclosures and found that none of them revealed new facts about the alleged fraud. The court therefore granted summary judgment to the defendants.

Williams and *Omnicom* are especially valuable to securities fraud defendants because they can be used to prevent plaintiffs from putting a laundry list of corrective disclosures before a jury.

For example, defendants may be able to use this precedent to exclude analyst reports and their accompanying price drops from the loss causation and damages analysis. Plaintiffs often seek to rely on these reports because an influential analyst who issues a negative report can move the stock price significantly.

These reports, however, generally do not disclose new facts, instead containing only the analyst's commentary on the fraud allegations and their effect on valuation. Under the *Williams* and *Omnicom* analysis, such reports cannot be corrective as a matter of law because they do not reveal any new facts about the fraud.

Another useful decision for defendants is *In re Apollo Group Inc. Securities Litigation*.²¹

After learning that one of its subsidiaries had violated Department of Education regulations, Apollo Group misrepresented the status of the agency's review by making public statements at odds with the DOE report.

In September 2004 the true contents of the DOE report were published in various newspapers, but Apollo's stock price did not react in a significant way. Five days later two analyst reports downgraded Apollo's stock, causing a selloff and a significant price decline.

Plaintiff shareholders sought to recover damage for that price decline, claiming that the analyst reports were corrective disclosures because they were necessary to reveal the truth about Apollo's previous misrepresentations. A jury agreed and found in favor of the plaintiffs.

Relying on *Omnicom* in their motion for judgment as a matter of law,²² the defendants maintained that the analyst reports could not qualify as corrective disclosures because they did not reveal new facts necessary to correct the falsity of prior misstatements or omissions. While the court refused to adopt this precise formulation of a corrective disclosure, it nonetheless found in the defendants' favor because the analyst reports did not provide any "new, fraud-revealing analysis."²³

In granting that a disclosure could be corrective based on "fraud-revealing analysis," the court rejected the "rigid, facts-only" approach of *Omnicom* and stood by its refusal in an earlier decision to find as a matter of law that the analysis of public facts can never be corrective.²⁴

The court based its opinion on a fear of providing perverse incentives for companies to provide piecemeal

or opaque disclosures designed to avoid market reaction to fraud revelations.

While the *Apollo* decision obviously is not as favorable to defendants as *Williams* or *Omnicom*, it still is valuable in several respects.

First, the court was careful to point out that fact-based corrective disclosures generally will be required: "[T]he typical securities fraud will be fully revealed through the disclosure of facts, without the need for any subsequent analysis. ... The situations in which the pertinent facts are obfuscated in such a way, or are of such complexity, as to require someone to connect the dots for a bewildered market represent a very rare type of securities fraud case."²⁵

*In other types of cases plaintiffs
can overstate damages without fear,
but they take a big risk doing so
in securities fraud class actions.*

With this statement the court affirmed its faith in efficient markets that do not need to wait for the commentary of reporters or analysts to price in factual revelations. Thus, unless the fraud was revealed through a very complex data analysis, *Apollo* does not preclude defendants from successfully arguing that a corrective disclosure must contain new facts about the fraud.

Second, the decision is important because the court overturned the jury's finding that the analyst reports were corrective. By granting a motion for judgment as a matter of law, the court demonstrated new vigilance in preventing plaintiffs from establishing damages by misclassifying disclosures as corrective.

*In re Hansen Natural Corp. Securities Litigation*²⁶ may also prove useful to many defendants.

In *Hansen* the plaintiffs alleged that the defendants engaged in stock-option backdating and improper accounting practices and attempted to show loss causation by pointing to three public disclosures.

The first disclosure revealed the beverage manufacturer had received a letter from the SEC asking the company to voluntarily produce documents about its stock option grant practices.

The second disclosure revealed that Hansen had formed a special litigation committee to conduct an investigation into the same matters.

The third disclosure announced that Hansen would not be able to file its 10-Q on time because of the investigation.

In finding that none of these disclosures was corrective, the court held that the “mere existence of [an] investigation cannot support any inference of wrongdoing or fraudulent *scienter* on the party of [a] company or its senior management.”²⁷

The *Hansen* disclosures did not reveal any facts about the alleged fraud, as *Omnicom* would require, nor did they analyze previously existing information to reveal the fraud, as *Apollo* would allow. Thus, those courts likely would agree with its outcome.

But *Hansen* is valuable to the defendants because it contradicts several earlier decisions that were more favorable to the plaintiffs.

In both *In re Bradley Pharmaceuticals Inc. Securities Litigation*²⁸ and *Montoya v. Mamma.com Inc.*,²⁹ the courts found that announcements of investigations by the SEC or a special litigation committee could be corrective.

While the logic of those decisions is unconvincing and they were decided before the better-reasoned decisions in *Omnicom* and *Apollo*, *Hansen* is useful for rebutting their outcomes.

Ignoring Confounding Information

The second step plaintiffs often use to exaggerate their damages involves them overestimating the stock price declines caused by the corrective disclosures identified in step one.

In securities fraud cases plaintiffs are entitled only to recover that portion of the stock price decline directly related to the fraud’s disclosure.³⁰ But stock prices do not move in a vacuum, and declines that accompany corrective disclosures often are the result of a myriad of factors unrelated to the fraud’s revelation, such as declines in the broader markets.

For this reason, isolating and removing non-fraud-related influences on stock price, sometimes referred to as “confounding information,” is an integral part of reliably estimating damages. Plaintiffs, however, regu-

larly attempt to connect the entire stock price decline to the fraud’s disclosure.

In an effort to avoid accounting for confounding information, some plaintiffs conflate the evidentiary showing needed to establish loss causation — which in some cases may not require the fraud’s effect on the stock price to be completely isolated — with the more precise showing required to prove damages.

As the 11th Circuit has noted, however, “[t]he distinction between the loss causation requirement and proof of damages is important ...; as long as the misrepresentation is one substantial cause of the investment’s decline in value, other contributing forces will not bar recovery under the loss causation requirement. But in determining recoverable damages, these contributing forces must be isolated and removed.”³¹

Confounding information can be accounted for properly using an event study, which is a statistical tool used to examine the effect of an event, such as a corrective disclosure, on a dependent variable, such as a company’s stock price.³²

An event study can show the true impact of a corrective disclosure by isolating and removing the three major factors that influence stock price:

- Market-wide factors;
- Industry-specific factors; and
- Company-specific factors unrelated to the fraud.³³

Plaintiffs and their experts often fail to properly account for these factors because they substantially reduce the plaintiffs’ damages estimate. While plaintiffs generally do not ignore the obvious effect of negative movements in the broader markets, they are likely to ignore industry- and company-specific factors, which can account for a large portion of the stock price decline.

The event study methodology makes it relatively easy to account for industry-specific factors using an index comprised of peer companies, but plaintiffs’ experts often will use an uncorrelated index chosen specifically to avoid fully accounting for these influences.

As for company-specific factors, these often prove more difficult for plaintiffs to account for, especially when the alleged corrective disclosure contains a variety of information that might affect the stock price.

A 10-K or 10-Q, for example, contains earnings, industry outlook, MD&A and earning guidance, and the effects on the stock price of this noncorrective information must be isolated and removed, presenting substantial hurdles for the plaintiffs' expert. As a result, plaintiffs often fail altogether to account for company-specific information, thus presenting defendants with an important opportunity to discredit plaintiffs' damages evidence.

Working in defendants' favor is an increased willingness by courts in the last 10 years to scrutinize damages calculations and a growing understanding of economic and financial principles. As a result, defendants now can rely on a strong body of precedent to attack experts who fail to account for confounding information that appears contemporaneously with revelation of the fraud.

Any discussion of measuring damages in securities fraud cases must begin with U.S. Circuit Judge Joseph Sneed's concurrence in *Green v. Occidental Petroleum Corp.*,³⁴ which was far ahead of its time and remains influential after 30 years.

Judge Sneed laid out the "value-line" framework for calculating damages, a framework intended to eliminate that portion of the stock price decline that is "the result of market forces unrelated to the wrong."³⁵

Although the "value-line" framework has been replaced to some extent by more complex event studies, Judge Sneed's opinion signaled to the judicial community that damages calculations in fraud-on-the-market cases require complex statistical analysis to ensure that plaintiffs do not recover more than they actually lost. His opinion also contributed to courts' willingness to require expert testimony on these issues and to delve into economic and financial issues they once may have avoided.³⁶

Unfortunately from the defense perspective, it took nearly 20 years for Judge Sneed's reasoning to catch on.

The influence of Judge Sneed's concurrence is seen in cases like *In re Oracle Securities Litigation*,³⁷ in which the plaintiffs professed to calculate their damages according to his value-line theory. However, after carefully scrutinizing the methodology of the plaintiffs' damages expert, the *Oracle* court found that the plaintiffs' "analysis fails to distinguish between the fraud-related and non-fraud related influences on the stock's price behavior."³⁸

Oracle is also significant in that it was the first time a court recommended an event study to calculate damages: "Use of an event study or similar analysis is necessary to more accurately isolate the influences of information specific to Oracle which defendants allegedly have distorted."³⁹

Green and *Oracle* laid the foundation for later cases like the 1997 decision *In re Executive Telecard Ltd. Securities Litigation*,⁴⁰ which remains an important decision on which defendants can rely.

In *Executive Telecard* the defendants moved to exclude the plaintiffs' damages expert for failing to take into account factors other than the alleged fraud that might have caused the company's stock price decline.

In addressing the principles for assessing the reliability of expert testimony, the court found that calculating damages in the securities fraud context "require[s] elimination of that portion of the stock price decline that is the result of forces unrelated to the wrong."⁴¹

And in an especially useful finding for defendants, the court noted that "a proper methodology for eliminating that portion of the price decline that is the result of forces unrelated to the wrong, should include elimination for both general market factors and *company-specific factors*."⁴²

The court ultimately rejected the damages evidence and noted several flaws in the plaintiffs' expert's analysis.

First, the court criticized the expert's failure to indicate whether he conducted an event study to determine if Executive Telecard's stock price was affected by "company-specific factors exclusive of the fraud."⁴³ These factors included a proposed spinoff of certain divisions that the plaintiffs themselves acknowledged was a significant concern to shareholders.

Second, the court criticized the expert for attempting to account for industry-specific factors by comparing the company's stock movements to movements in the S&P Telecommunications Index when in fact Executive Telecard's stock was much more volatile and did not correlate with that index.

More recently a variety of courts have shown a willingness to scrutinize expert damages reports.

For example, in *In re Imperial Credit Industries Inc. Securities Litigation*⁴⁴ the court excluded the report of a damages expert who failed to conduct an event study and then granted summary judgment to the defendants,

saying there was “no legally sufficient evidentiary basis for a reasonable jury to find for plaintiffs as to the existence of loss causation and damages.”

In *Carpe v. Aquila Inc.*⁴⁵ the court excluded the damages report of an expert who conducted an event study but whose methodology failed to adequately account for industry-specific factors. Rather than comparing Aquila to an index of peer companies, the expert only compared Aquila to a single energy company, thus rendering his analysis fatally flawed.

Courts also continue to reject expert reports that fail to account for confounding information.

For example, in *Williams*, the court emphasized that the plaintiffs’ loss causation analysis must account for company-related information unrelated to the fraud.⁴⁶

There, the plaintiffs’ second allegedly corrective disclosure contained two announcements:

- The company’s lenders had informed it that it might be in default under its credit arrangements; and
- The company was performing a review of the possible impairment of its long-lived assets.⁴⁷

In evaluating the plaintiffs’ experts’ analysis, the court questioned why “one would allot all of the price decline to the revelation of the fraud and not to another significant piece of negative information that was released that day.”⁴⁸

The court ultimately concluded that the expert’s failure to disentangle fraud-related news from confounding information “renders his methodology unreliable.”⁴⁹

In *Oscar Private Equity Investments v. Allegiance*⁵⁰ the court noted that the plaintiffs’ event study supported a “finding that Allegiance’s stock reacted to the *entire bundle* of negative information contained in the 4Q01 announcement.”⁵¹

The court found, however, that “this reaction suggests only market efficiency, not loss causation, for there is no evidence linking the *culpable* disclosure to the stock-price movement. When multiple negative items are announced contemporaneously, mere proximity between the announcement and the stock loss is insufficient to establish loss causation.”⁵²

Although decided in the context of loss causation, *Oscar* remains relevant to all event studies designed

to eliminate factors unrelated to the fraud. If failure to disentangle multiple negative items were grounds to reject an event study intended to prove loss causation, it follows that such a flaw also would lead to rejection when an event study is intended to prove damages.

Oscar’s holding recently was applied in *Fener v. Belo Corp.*,⁵³ in which the defendants opposed class certification on the ground that the plaintiff “failed to prove that the Aug. 6, 2004, stock price decline was not caused by other negative, non-fraud-related information contained in the Aug. 5 announcement.”⁵⁴

After finding that “contrary to plaintiff’s assertions, the Aug. 5 announcement is composed of various news pieces”⁵⁵ and that “plaintiff does not even attempt to address each of the multiple announcements individually, much less demonstrate how they are related to”⁵⁶ the alleged fraud, the court rejected the plaintiff’s expert report on loss causation and denied class certification.

Again, while this is a loss causation decision, it remains useful for defendants in opposing any improperly conducted event study.

Conclusion

While in other types of cases plaintiffs can overstate damages without fear of negative consequences, plaintiffs take a big risk by doing so in securities fraud class actions.

If defendants can exclude plaintiffs’ proffered expert evidence of loss causation or damages as unreliable, defendants are likely to prevail on summary judgment. It therefore is vital that defendants understand how plaintiffs overstate their damages and use every available opportunity to expose plaintiffs’ unreliable methodologies to the court. And as courts continue to gain increased comfort with the economic and financial principles underlying these calculations, defendants’ success should only grow.

Until plaintiffs are willing to abandon these unreliable methodologies, defendants will continue to have opportunities to exploit the flaws in plaintiffs’ loss causation and damages evidence.

In part two of this series we will tackle the third step in plaintiffs’ efforts to exaggerate their damages: aggregate damages models.

Plaintiffs use unreliable and unproven statistical models to estimate the total number of damaged

shares, which they multiply by their inflated per-share damages figure to arrive at a grossly inflated estimate of total damages.

Although the courts so far have firmly rejected these models, plaintiffs continue to develop new methods designed to withstand *Daubert* scrutiny and justify high settlement demands. Their new methods, however, remain unreliable, unproven and untestable, and courts should continue to reject them.

Notes

- ¹ 544 U.S. 336 (2005).
- ² For example, both the announcement of an internal investigation and an auditor's resignation, neither of which revealed any facts about the underlying fraud to investors, were found to be potentially corrective. See *Montoya v. Mamma.com Inc.*, 2006 WL 770573, at *8 (S.D.N.Y. Mar. 28, 2006).
- ³ 558 F.3d 1130 (10th Cir. 2009).
- ⁴ See *id.* at 1134-35.
- ⁵ *Id.* at 1138.
- ⁶ *Id.* at 1135.
- ⁷ *Id.* at 1138.
- ⁸ *Id.*
- ⁹ *Id.* (emphasis in original).
- ¹⁰ *Id.* at 1137-38.
- ¹¹ See 544 U.S. at 345.
- ¹² 558 F.3d at 1139.
- ¹³ *Id.*
- ¹⁴ *Id.* at 1140.
- ¹⁵ *Id.* at 1142.
- ¹⁶ *Id.*
- ¹⁷ 541 F. Supp. 2d 546, 552-53 (S.D.N.Y. 2008).
- ¹⁸ *Id.* at 551.
- ¹⁹ *Id.*
- ²⁰ *Id.* at 551-52.
- ²¹ 2008 WL 3072731 (D. Ariz. Aug. 4, 2008). The Apollo plaintiffs have appealed, and the case is pending in the 9th Circuit. See App. Dkt. No. 08-16971.
- ²² Federal Rule of Civil Procedure 50 allows the judge to grant a motion for judgment as a matter of law after a jury trial if a "reasonable jury would not have a legally sufficient basis to find for the party on [an] issue" and the claim requires a "favorable finding on that issue."
- ²³ 2008 WL 3072731, at *3.
- ²⁴ *Id.*
- ²⁵ *Id.*
- ²⁶ 527 F. Supp. 2d 1142 (C.D. Cal. 2007).
- ²⁷ *Id.* at 1162.
- ²⁸ 421 F. Supp. 2d 822, 829 (D.N.J. 2006).
- ²⁹ 2006 WL 770573, at *8 (S.D.N.Y. Mar. 28, 2006).
- ³⁰ See, e.g., *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1342 (9th Cir. 1976).
- ³¹ *Robbins v. Koger Props.*, 116 F.3d 1441, 1447 n.5 (11th Cir. 1997).
- ³² See *In re Imperial Credit Indus. Inc. Sec. Litig.*, 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003).
- ³³ See *In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1348 (N.D. Cal. 1994) ("An analysis of these residual or unexplained price changes is undertaken to determine which of these might

be explained by influence of firm-specific, but not-fraud related, information, and which might be attributed to the fraud alleged.").

- ³⁴ 541 F.2d 1335, 1341-46 (9th Cir. 1976).
- ³⁵ *Id.* at 1342.
- ³⁶ See *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 529 F. Supp. 2d 644, 720 (S.D. Tex. 2006) ("Judge Sneed's concurrence prefaced a significant trend of courts' requiring more sophisticated damages calculations with analysis of how factors that impact stock price, including ones unrelated to the fraud, and of how to exclude general factors such as overall stock price decline, or factors that impact the particular industry or company that are not fraud related, in an effort to base damages only on those factors that actually relate to the alleged fraudulent activity.").
- ³⁷ 829 F. Supp. 1176 (N.D. Cal. 1993).
- ³⁸ *Id.* at 1181.
- ³⁹ *Id.*
- ⁴⁰ 979 F. Supp. 1021 (S.D.N.Y. 1997).
- ⁴¹ *Id.* at 1025.
- ⁴² *Id.* at 1026 (emphasis added).
- ⁴³ *Id.* at 1025.
- ⁴⁴ 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003).
- ⁴⁵ 2005 WL 1138833, at *4 (W.D. Mo. Mar. 23, 2005).
- ⁴⁶ 558 F.3d at 1137.
- ⁴⁷ *Id.* at 1142.
- ⁴⁸ *Id.*
- ⁴⁹ *Id.*
- ⁵⁰ 487 F.3d 261 (5th Cir. 2007).
- ⁵¹ *Id.* at 271 (emphasis in original).
- ⁵² *Id.* (emphasis in original).
- ⁵³ 560 F. Supp. 2d 502 (N.D. Tex. 2008).
- ⁵⁴ *Id.* at 504.
- ⁵⁵ *Id.* at 505.
- ⁵⁶ *Id.* at 506.

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When Plaintiffs Overreach: Attacking Flawed Evidence of Loss Causation and Damages in Securities Class Actions

Part 2

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This is the second article in a two-part series focusing on strategies plaintiffs employ to distort evidence of loss causation and damages.

Part one examined plaintiffs' efforts to overstate damages by:

- “Over-identifying” corrective disclosures; and
- Failing to account for confounding information.

This article examines plaintiffs' use of unreliable and untestable trading models to generate aggregate damages estimates, and evaluates a new and equally flawed trading model.

In securities class actions there is often a dispute as to whether, after making the requisite findings on liability, loss causation and per-share damages, a jury should be permitted to go a step further and determine aggregate damages to the class.

Aggregate damages are calculated by multiplying per-share damages by the total number of damaged shares. Thus, in order to calculate aggregate damages, the jury must be presented with evidence showing the number of shares purchased during the class period and held through the corrective disclosure date(s) (*i.e.*, the revelation[s] of the alleged fraud).

Although changes in stock ownership are recorded by transfer agents and the major exchanges, it is impossible to ascertain each class member's trading behavior from that data. Trades frequently occur in “street name” (*i.e.*, the name of a broker or other nominee instead of the customer) or through depository institutions that obscure, if not effectively eliminate, the buyers' and sellers' identities.¹

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As a result, it is impossible to determine who has actually bought and sold the stock without access to the class members' individual trading records.

Importantly, it is also impossible to identify which shares were purchased during the class period and held through the corrective disclosure date(s). Only those shares were damaged, but the available data provides no means by which to calculate their number.

There is often a dispute in securities class actions as to whether a jury should be permitted to determine aggregate damages to the class.

To illustrate, assume on day one of the class period that 1 million shares of the defendant company changed hands, that 100,000 of those shares were purchased in ABC brokerage's name for its clients and that 50,000 were sold in ABC brokerage's name for its clients.

How many of those trades were day trades? How many of the purchases were subsequently sold the next day, the next week or the day before the corrective disclosure that results in a stock drop?

Based on a lack of loss causation, none of the shares sold on those subsequent days would qualify as damaged. But the available data for ABC brokerage's trades lacks the specificity to determine the buy/sell history of each individual investor. As a result, identifying and quantifying damaged shares is impossible.

To plug this informational gap, plaintiffs have attempted to employ statistical trading models to estimate to total number damaged shares.

The various models developed by plaintiffs' experts, however, have proven unreliable and inaccurate and have been repeatedly rejected by courts.

In excluding these models, courts often note that a post-trial claims process can be instituted in which class members submit evidence of their trading activity to establish their entitlement to damages. This process thus ensures that plaintiffs recover only for shares actually damaged.

Although the trading models' shortcomings are well-documented, plaintiffs continue to promote such models for two reasons.

First, without fail, they result in a massive overstatement of total damages.

A 2006 study of 46 securities fraud cases compared the aggregate damages estimates generated by two popular trading models with the aggregate damages claims actually submitted.²

In all 46 cases the aggregate damages estimates generated by the trading models exceeded actual damages, sometimes by as much as a factor of seven.³ On average both trading models resulted in aggregate damages estimates of more than two and a half times higher than actual aggregate damages.⁴

With statistics like these it is easy to see why judicial acceptance of trading models is something of a holy grail to plaintiffs' counsel.

Second, an aggregate damages awards immediately provides plaintiffs' counsel a number on which to base their fee request (which is typically a percentage of that award). By contrast, the claims administration process often takes more than a year to complete and requires plaintiffs' counsel to expend additional resources. Only after that process is complete and total damages have been accurately measured can plaintiffs' counsel submit a fee request.

Thus, under a per-share damages award, plaintiffs' counsel receives not only less money but also must wait longer to receive it — hence the desire to avoid this outcome.

Traditional Trading Models

The two most well-known trading models are the "proportional trading model" and the "two-trader model," both of which have been rejected by the courts as unreliable under *Daubert v. Merrell Dow Pharmaceuticals Inc.*, 509 U.S. 579 (1993).

In *Kaufman v. Motorola Inc.*, the court evaluated a challenge to the plaintiffs' experts' use of the PTM and considered the four factors set forth in *Daubert*:

- Whether the theory or technique can be and has been tested;
- Whether the technique or theory has been subjected to peer review and publication;
- The known or potential rate of error; and
- The general acceptance of the theory.⁵

The court concluded that the PTM “does not meet any of the *Daubert* standards.” It further noted that it “has never been tested against reality” and “has never been accepted by professional economists.”⁶ The court also said the PTM “seems to be a theory developed more for securities litigation than anything else.”⁷

In excluding the expert’s testimony, the court also found the use of a trading model unnecessary because “an adequate remedy may be fashioned by having the jury determine a per-share damage loss and requiring the filing of claims by each shareholder who claims that he, she or it has been damaged.”⁸

*Various statistical models developed
by plaintiffs’ experts have
proven unreliable and inaccurate.*

In *In re Broadcom Corp. Securities Litigation*,⁹ the defendants moved to exclude the plaintiffs’ experts’ use of the two-trader model to generate an aggregate damages estimate. In finding that the proposed trading model did not satisfy any of the *Daubert* factors, the court noted that:

The technique has not been tested against “real world” conditions and probably cannot be so tested unless a different set of test protocols is established. It has not been subjected to the sort of critical peer review and publication that one would expect as a prerequisite for jury acceptance. The potential error rate is highly questionable and is based on a set of criteria that undermines the claimed error rate as being truly representative of the facts sought to be proved. Although held out by litigation professionals as useful in securities litigation, most notably as a settlement aid, the technique is not generally accepted in what is the relevant scientific community — professional economists. The *Daubert* criteria are not exclusive, and the court has considered others suggested by plaintiffs, but the court is unable to find other indicators of reliability or acceptability that would satisfy *Daubert*’s requirement.¹⁰

As in *Kaufman*, the court concluded that it “need not use a proof method of questionable reliability when an alternative, completely reliable method is available through the claims administration process.”¹¹

Thus, as both *Kaufman* and *Broadcom* demonstrate, damages in securities class actions should be determined by a jury on a per-share basis. There is simply no need to present an aggregate damages estimate when the claims administration process guarantees accuracy and prevents unjust enrichment of plaintiffs and their counsel. This is especially important given the magnitude by which plaintiffs’ trading models overstate damages.

Renewed Efforts to Overcome Daubert

Although *Kaufman* and *Broadcom* were significant setbacks to the use of trading models, plaintiffs’ experts continue to develop new models they hope will withstand *Daubert* scrutiny. These new models, however, are no more accurate and reliable than those already rejected by the courts. In fact, plaintiffs’ experts have done little more than repackage the same “junk science” designed to consistently overstate damages.

A recent example of plaintiffs’ efforts is the trademarked “theoretically grounded microstructure trading model,” or TMTM, that Linda Allen, Baruch College professor of economics and finance, developed and advanced in three publications:

- An article in the Stanford Journal of Law, Business and Finance titled “A New Theoretically Grounded Microstructure Trading Model for Calculating Damages in Shareholder Class-Action Litigation”;¹²
- An article in The Business Lawyer titled “Meeting *Daubert* Standards in Calculating Damages for Shareholder Class-Action Litigation”;¹³ and
- A U.S. patent application titled “Arrangement for and a Method of Determining Damages in Shareholder Class-Action Litigation.”¹⁴

In her writings, Allen concedes that most trading models have significant shortcomings. She notes that “the restrictive and unrealistic assumptions of the proportional trading model have been criticized by experts and courts alike”¹⁵ and concludes that the two-trader model “does not fare much better” because it “arbitrarily posits the existence of two types of traders with different trading intensities.”¹⁶

She also acknowledges that the TTM cannot be tested against reality because “there is often no database available to calibrate the TTM method’s assumptions.”¹⁷

But while Allen purports to overcome these shortcomings with the TMTM, even a cursory examination of her methodology shows it is equally unreliable.

The goal of the TMTM is to identify shares bought and sold by retail investors during the class period and determine how many of the purchased shares were held through the corrective disclosure date(s).¹⁸

There are two steps in Allen's analysis.

In the first step each trade during the class period is categorized as a retail buy or a retail sell. This is accomplished allegedly by applying the modified quote rule¹⁹ and the tick rule²⁰ to publicly available intraday trading data. For each day in the class period, those trades classified as retail sells are subtracted from the retail buys, and the results are summed over the entire class period to provide an initial estimate of damaged shares.

In step two the initial estimate is adjusted to account for the fact that many of the retail sells consisted of shares purchased before the class period started, and thus were improperly subtracted from step one's damaged-share estimate. The adjustment factor is based on the daily propensity to trade, which Allen claims is a function of the stock's liquidity as measured by the bid-ask spread.

While Allen repeatedly claims that the "TMTM method meets *Daubert* standards of reliability,"²¹ even stating as much in her patent application, the model falls far short of those standards. In fact, it contains three major flaws that render it unreliable and inadmissible.

First, Allen's methodology enables the damaged-shares estimate to grow without limit. Because the TMTM equation is not related to float, or the total number of outstanding shares available for trading, given a long enough class period, the TMTM will generate a damaged shares estimate that exceeds the float.²²

This flaw can be demonstrated using the Enron data included in Allen's patent application.

Using a hypothetical 90-day class period, the TMTM model estimates that more than 95 million Enron shares were damaged.²³ But the real Enron class period was more than four years.

When the model is run using a class period of that length, it generates a damaged share estimate far in excess of Enron's total outstanding shares — a result that is absurd on its face. It is clearly impossible for there to have been more shares held when the fraud was revealed than there are shares outstanding. This flaw, standing alone, warrants judicial exclusion of the TMTM.

Models that can massively overstate damages remain highly attractive to plaintiffs and are unlikely to disappear anytime soon.

Second, although Allen purports to calculate her propensity-weighted adjustment factor based on the bid-ask spread and the stock's liquidity, she does no such thing. Instead, the variables input into her model are the daily low bid and the daily high ask for each day of the class period.²⁴ But those variables are not equivalent to the average bid-ask spread used in the academic research on which her model is supposedly based.²⁵

The bid-ask spread, by definition, is the difference between the price quoted for an immediate sale (the bid) and an immediate purchase (the ask). The difference between the bid and the asking price over an extended period is thus referred to as the average bid-ask spread.

Relying on the daily low bid and the daily high ask, as Allen does in her model, is wholly illogical and generates a meaningless figure unrelated to liquidity.

For example, a highly liquid stock with a very small bid-ask spread may experience a significant price move due to an intraday news release. If the stock's opening price were \$2 lower than its close, the daily low bid would be significantly lower than the daily high ask, and the difference between those numbers using Allen's methodology would produce a large average bid-ask spread. But those numbers are unrelated to what the actual bid-ask spread in that highly liquid stock was during the trading day.

Thus, by using the daily low bid and the daily high ask in her trading model, Allen fails to incorporate any measure of liquidity even though liquidity is the cornerstone of the propensity to trade research on

which she relies.²⁶ This serious error renders her adjustment factor and model fatally flawed.

Third, Allen contends that the “categorization of daily share volume into the number of shares bought and sold by *retail customers*,”²⁷ as is allegedly done by the TMTM, is an improvement over existing trading models (such as the PTM and the TTM) that rely on aggregate trade volume.²⁸

But the TMTM does nothing more than identify buyer- and seller-initiated trades within the aggregate daily volume — it does not establish whether those trades were executed by retail or institutional investors.

Allen illogically concludes that buyer- and seller-initiated trades are equivalent to retail buy and sell volumes, a proposition for which she offers no support. Moreover, there is no reliable way to separate institutional trades from retail trades using Allen’s trading data.

The only known characteristic of the trades, other than their execution price in relation to the bid-ask spread, are their volume. But volume standing alone does not reveal the identity of the purchaser.

Many institutional investors now break their purchases up into small blocks and use trading algorithms to make large purchases over several days. A review of trading data recently filed in federal court by one of the nation’s largest pension funds confirms that institutional trades often consist of less than 10,000 shares,²⁹ a benchmark sometimes used to denote an institutional purchase in academic literature.

While perhaps it could be argued that large trades should be excluded from Allen’s retail trade data as likely to have been made by institutions, a vast majority of trades are incapable of being labeled as either retail or institutional based on her data. Thus, there is no basis for the assertion that she is identifying shares bought and sold by retail customers.

In addition to these three specific flaws in Allen’s methodology, the TMTM has many of the same shortcomings as other trading models and fails to satisfy any of the *Daubert* factors.

First, like the PTM and the TTM before it, the TMTM has not and cannot be tested against reality and as a result has no known error rate. Allen purports to “test” the TMTM by comparing its estimates to estimates generated by the PTM and the TTM.

She observes that her estimates fall between those generated by the PTM and TTM and concludes that this demonstrates the model’s improved reliability.³⁰ But this is nonsensical. She acknowledges that the estimates generated by those models are fundamentally flawed and unreliable, so demonstrating that the TMTM’s estimates fall somewhere in between those estimates proves nothing about the model’s reliability.

Second, for all the reasons outlined above, the TMTM has and will not be accepted by professional economists. Any model that can generate a damaged shares estimate that exceeds the stock’s float is unreliable and patently useless to economists.

Third, there is no question that this model was prepared exclusively for use in litigation, as demonstrated by the title of Allen’s publications on this topic. This also weighs heavily against its admissibility in future litigation.³¹

Conclusion

While *Kaufman* and *Broadcom* may have marked the end of the PTM and the TTM, plaintiffs and their experts will continue to search for new trading models that can withstand *Daubert* scrutiny.

The TMTM is just one example of what is likely to be multiple new entrants in this field. While Allen’s model falls far short of meeting the standards set forth in *Daubert*, and should be rejected by courts in short order, defendants should be prepared to face this and similar efforts going forward.

The ability of these models to massively overstate damages remains highly attractive to plaintiffs, so they are unlikely to disappear anytime soon.

Notes

- ¹ A vast majority of trades are cleared through the Deposit Trust & Clearing Corp. The DTCC has a number of subsidiaries, including the Deposit Trust Co., which holds all stock in the name of its partnership nominee, Cede & Co.
- ² See Daniel R. Fischel, David J. Ross & Michael A. Keable, *The Use of Trading Models To Estimate Aggregate Damages In Securities Fraud Litigation: An Update*, AEI LEGAL CENTER BRIEFLY, Vol. 10, No. 3, March 2006, at 18-19.
- ³ *Id.* at 19.
- ⁴ *Id.*
- ⁵ 2000 WL 1506892, at *1 (N.D. Ill. Sept. 21, 2000) (citing *Daubert v. Merrell Dow Pharms.*, 509 U.S. 579 (1993)).
- ⁶ *Id.* at *2.
- ⁷ *Id.*

- ⁸ *Id.*
- ⁹ 2005 WL 1403756, at *1 (C.D. Cal. June 3, 2005).
- ¹⁰ *Id.* at *2.
- ¹¹ *Id.* at *3.
- ¹² Linda Allen, *A New Theoretically-Grounded Microstructure Trading Model for Calculating Damages in Shareholder Class-Action Litigation*, STAN. J.L. BUS. & FIN., Vol. 12, No. 1, Autumn 2006.
- ¹³ Linda Allen, *Meeting Daubert Standards in Calculating Damages for Shareholder Class-Action Litigation?*, BUS. LAW, Vol. 62, No. 3, May 2007.
- ¹⁴ Linda Allen, "Arrangement for and a Method of Determining Damages in Shareholder Class-Action Litigation," U.S. Patent App. No. 2007/0299788 A1, Dec. 27, 2007.
- ¹⁵ *Id.* at 1.
- ¹⁶ *Id.* at 2.
- ¹⁷ *Id.*
- ¹⁸ *Id.*
- ¹⁹ The modified quote rule classifies a purchase as a transaction executed at the ask quote, while a sale is executed at the bid quote. *Id.*
- ²⁰ The tick rule is based on a comparison of the transaction price to the previous trade. Transactions occurring above the last price are assumed to be initiated by a retail buyer, while those occurring below are assumed to be initiated by a retail seller. *Id.*
- ²¹ See, e.g., *id.*
- ²² Table 4 of Allen's patent application demonstrates that the number of retained (damaged) shares grows without limit, as days on which there are more retail sells than buys are assumed to have resulted in zero retained shares rather than reducing the total number of damages shares. *Id.* at 9-10.
- ²³ *Id.* at 10.
- ²⁴ *Id.* at Fig. 8; see also *Meeting Daubert*, *supra* note 13, at 967.
- ²⁵ See Kenneth D. Garbade, *The Effect of Interdealer Brokerage on the Transactional Characteristics of Dealer Markets*, J. BUS., Vol. 51, No. 3, 1978.

- ²⁶ It should also be noted that the research on which Allen based her adjustment factor does not relate to the propensity with which equity investors trade. Instead, the paper (and formula) relied upon by Allen presents a model of order flows in the market for U.S. Treasury securities in the 1970s, a market structure far different than that of modern exchanges. See *supra*, n. 26.
- ²⁷ Patent App. at 2 (emphasis added).
- ²⁸ *Id.* at 4.
- ²⁹ Consolidated complaint at Sch. A, *In re UnitedHealth Group PSLRA Litig.*, No. 06-01691, No. 149 (D. Minn. Dec. 8, 2006) (providing trading data that demonstrates 57 percent of CalPERS' trades in UnitedHealth stock were less than 10,000 shares, while co-plaintiff Alaska Plumbing & Pipefitting Industrial Pension Trust did not make a single trade over 10,000 shares).
- ³⁰ Patent App. at 6.
- ³¹ See *Daubert v. Merrell Dow Pharms.*, 43 F.3d 1311, 1317 (9th Cir. Cal. 1995) ("One very significant fact to be considered is whether the experts are proposing to testify about matters growing naturally and directly out of research they have conducted independent of the litigation, or whether they have developed their opinions expressly for purposes of testifying.").

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