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Second Circuit Affirms the Importance of Adequately Pleading Loss Causation in Securities Fraud Claims

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On February 2, 2011, the U.S. Court of Appeals for the Second Circuit handed down its opinion in ***Amorosa v. AOL Time Warner, Inc.***, one of the last cases stemming from an alleged fraud perpetrated by AOL executives pursuant to a merger with Time Warner. AOL executives allegedly overstated their revenues, profits and future business prospects in order to secure the merger. Afterwards, while the company's stock prices were still artificially inflated, executives allegedly cashed in hundreds of millions of dollars in personal shares, ultimately triggering a massive plummet in the value of the company's stock.

The plaintiff, a holder of common stock in America Online predating the company's merger with Time Warner, brought suit in federal court, alleging fraudulent accounting practices by AOL's accounting firm, Ernst & Young. The allegations stemmed from a "clean" audit opinion provided by Ernst & Young prior to the merger, which, according to plaintiff, ultimately led to the dramatic decline in the value of his stock. Specifically, plaintiff alleged violations of Sections 14(a) and 10(b) of the Securities Exchange Act of 1934.[1]

The U.S. District Court for the Southern District of New York dismissed plaintiff's Section 14(a) and 10(b) claims for failure to adequately plead that Ernst & Young's alleged misrepresentations proximately caused his investment losses (this causal link—referred to as "loss causation"—is a requisite component of securities fraud claims). Plaintiff appealed to the Second Circuit Court of Appeals, which affirmed the district court's rulings. Regarding the Section 14(a) and 10(b) claims, the appellate court held that it was plaintiff's burden to plead and prove loss causation, and that he had failed to do so. Plaintiff's attempt to plead loss causation consisted of his allegation that, as the public became aware of AOL Time Warner's accounting practices, his stock lost value.

In assessing the sufficiency of plaintiff's securities claims, the appellate court articulated the standard for proving loss causation under a "materialization of risk" theory: a plaintiff must show that "the fraudulent statement or omission concealed something from the market that, when disclosed, negatively affected the value of the security." Plaintiff had to allege specific misstatements or omissions made by the defendant that were connected to his eventual economic loss. Because plaintiff alleged only that Ernst & Young's audit report was the cause of his losses, but did not point to any specific misrepresentations or omissions regarding the disputed report or AOL's accounting practices in general, the Second Circuit affirmed the district court's dismissal of plaintiff's securities fraud claims.

With its holding, the Second Circuit further entrenched the importance of pleading and proving loss causation in securities fraud cases. In the process, it demonstrated that even sympathetic plaintiffs who appear to have suffered legitimate pecuniary injury from an alleged fraud—which, in this case, resulted in the SEC bringing multiple civil suits against AOL executives—will be given no quarter when they fail to meet this requirement.

Application to Securities Fraud Cases Generally

There is no appellate-circuit-transcending standard for pleading and proving loss causation, and many cases explain only what does *not* amount to loss causation. *See*, *e.g.*, *Dura Pharms., Inc. v. Brudo*, 544 U.S. 336, 342 (2005) (plaintiff's demonstration that the price of a security on its date of purchase was inflated due to an alleged misrepresentation was insufficient to plead loss causation); *New York City Employees Ret. Sys. v. Jobs*, 593 F.3d 1018, 1023–24 (9th Cir. 2010) (allegation of share dilution was insufficient to plead loss causation because economic loss does not necessarily accompany dilution).

Some courts, however, have articulated clearer guidelines. The Seventh Circuit, for example, has spelled out three theories of loss causation: (1) materialization of risk; (2) fraud on the market; and (3) risk-free assurance by defendant. *See Ray v. Citigroup Global Mkts., Inc.*, 482 F.3d 991, 995 (7th Cir. 2007). The standard for the materialization of risk theory—claimed by the plaintiff in *Amorosa*—is discussed above. For the fraud-on-the-market theory, a plaintiff must show "both that the defendants' alleged misrepresentations artificially inflated the price of the stock and that the value of the stock declined once the market learned of the deception." *Id*. Finally, under the aptly named "risk-free assurance by defendant" theory, a plaintiff must show that a broker falsely assured him or her that the disputed investment was risk free.

Looking Forward

The issue of loss causation will be addressed by the Supreme Court this month, when it hears *Erica P. John Fund, Inc. v. Halliburton Co.*, on appeal from the Fifth Circuit. At issue in that case is whether loss causation must be established as a prerequisite for class certification, or whether it is an issue best left for trial.

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1 Plaintiff's complaint contained other allegations as well, but such claims are beyond the scope of this article and were dismissed along with the securities fraud claims.