Public Disclosure of Government Investigation Can Establish Loss Causation, Ninth Circuit Holds

A publicly traded company that discloses the existence of a government investigation is almost certain to see its stock price decline. But until recently, companies could take comfort in decisions holding that such a disclosure is not enough to establish loss causation in a private securities fraud case. The other shoe has now dropped.

The Ninth Circuit recently became the first federal circuit court to expressly hold that the public disclosure of an SEC investigation can form the basis of a viable loss causation theory, if the defendant also made a subsequent corrective disclosure. Lloyd v. CVB Fin. Corp., No. 13-56838, ___ F.3d ___, 2016 WL 384773 (9th Cir. Feb. 1, 2016). In fact, although Lloyd involved an SEC investigation, the opinion is not limited to SEC investigations, or even to government investigations, but applies equally to the public disclosure of a company’s internal investigation. Although a handful of district courts had adopted this theory or one like it, it is certain to gain more traction now.

The Issue of Loss Causation

Loss causation is one of six elements that plaintiffs must prove to recover on a private securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. To prove loss causation, plaintiffs must show that the defendant’s deceptive conduct—rather than some other intervening event—caused the plaintiff’s claimed economic loss. Plaintiffs typically prove loss causation by showing that the defendant revealed the inaccuracy of its misrepresentation through corrective disclosures that caused the company’s stock price to drop.

Factual Background of Lloyd

The plaintiff in Lloyd could not prove loss causation in the typical manner. It sued CVB for alleged misrepresentations in its SEC filings. CVB had represented in those filings that there was no basis for “serious doubt” about its largest borrower’s ability to repay its loans; the plaintiff, however, alleged that CVB knew its borrower was on the verge of bankruptcy. Before CVB had a chance to correct its prior disclosures, the SEC served a subpoena on CVB seeking information about its loan processes and its methodology for grading loans. CVB then disclosed the subpoena—and its stock dropped 22%, with analysts noting the probable relationship between the subpoena and the loans. One month later, CVB announced that it had written down $34 million in loans to the borrower and placed another $48 million into non-performing status. Its stock fell “only slightly” after this announcement. Thus, the plaintiff could not link its economic losses to CVB’s corrective disclosure.

The district court ruled that the plaintiff had failed to adequately allege loss causation. The decision followed then-existing law in the Ninth Circuit (and elsewhere) holding that the disclosure of an SEC investigation does not qualify as a “corrective disclosure” because it “does not reveal to the market the pertinent truth of anything.” Id. at *8 (internal quotations omitted).

The Ninth Circuit’s Decision

The Ninth Circuit vacated the district court’s dismissal. The Ninth Circuit held that the “disclosure of the SEC investigation related to an alleged misrepresentation, coupled with a subsequent revelation of the inaccuracy of that misrepresentation, can serve as a corrective disclosure for the purpose of loss causation.” Id. at *1. The court noted that any other rule would allow defendants to escape liability by first announcing a government investigation, and then waiting until the market reacted before revealing that their prior representations were false.

Although the court confirmed that the disclosure of an SEC investigation on its own still does not establish loss causation, it found that the plaintiff in Lloyd had alleged “much more.” In particular, the plaintiff had alleged that CVB’s stock dropped significantly as a result of the initial disclosure; that CVB’s subsequent corrective disclosure confirmed the suspicions analysts had written about one month earlier; and that the market had already adjusted its view of CVB’s stock based on the original disclosure—as evidenced by the fact that the price moved “hardly at all” in response to CVB’s “bombshell disclosure” about its largest borrower. In other words, the allegations demonstrated that investors “understood the SEC announcement as at least a partial disclosure of the inaccuracy of the previous ‘no serious doubts’ statements.” Id.
Takeaways

The Ninth Circuit’s decision in Lloyd raises the stakes in securities fraud cases by eliminating—or at least significantly limiting—a common argument for defendants on motions to dismiss. Even more, it may embolden prospective plaintiffs (or plaintiffs’ lawyers) to file claims they might otherwise have deemed too risky. Although the disclosure of a significant SEC investigation might previously have broken the chain of causation between investors’ losses and a company’s corrective disclosures, the Ninth Circuit’s decision in Lloyd places that disclosure squarely back into the chain. Whether other federal circuits follow the Ninth Circuit on this issue remains to be seen. But the trend certainly appears headed in that direction.

[1] See, e.g., Loos v. Immersion Corp., 762 F.3d 880, 890 n.3 (9th Cir. 2014); Meyer v. Greene, 710 F.3d 1189, 1201 n.13 (11th Cir. 2013).


[3] The others are (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; and (5) economic loss. Lloyd, 2016 WL 384773, at *4.

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