Sarbanes-Oxley at Five

SOX's Whistleblower Provision–Promise Unfulfilled

BY JASON M. ZUCKERMAN

Jason M. Zuckerman, Principal of The Law Office of Jason M. Zuckerman, PLLC and Of Counsel at The Employment Law Group, P.C., litigates whistleblower retaliation claims under the Sarbanes-Oxley Act, the False Claims Act, and various federal and state whistleblower protection laws. Contact: jzuckerman@zuckermanlaw.com.

[The following article is one of several Securities Litigation Report will be presenting beginning in this issue and continuing over the next several months about the fifth anniversary of the passage of the Sarbanes-Oxley Act.]

In enacting the most comprehensive securities law and investor protection reform in more than half a century, Congress made whistleblower protection a central tool to improve the accuracy and reliability of corporate disclosures. To ensure that employees with first-hand knowledge of accounting fraud feel that they can raise concerns without jeopardizing their livelihood, Congress enacted Section 806 of the Sarbanes-Oxley Act ("SOX"), which was intended to provide robust protection for whistleblowers.[1] As stated in the legislative history, "U.S. laws need to encourage and protect those who report fraudulent activity that can damage innocent investors in publicly traded companies."[2]

Five years after its enactment, Section 806 has failed to live up to its promise. Indeed, a recent empirical study found that the Department of Labor ("DOL") has strictly construed, and in some cases misapplied, Section 806, and that less than 5% of whistleblowers prevailed in Section 806 claims before DOL.[3] In addition, the Department of Labor's Administrative Review Board ("ARB") recently judicially amended Section 806 by imposing a standard for protected conduct that is contrary to the plain meaning and intent of the statute. Despite these developments, however, Section 806 can potentially provide strong protection to whistleblowers, and it has sensitized employers to the importance of encouraging employees to report financial misconduct and taking prompt remedial action to correct accounting fraud or securities law violations. This article discusses how the elements of a Section 806 claim have been interpreted, focusing primarily on the scope of protected conduct.

Protected Conduct

Section 806 of SOX protects employees who provide information to management, a Federal agency, or Congress relating to alleged violations of the federal mail, wire, radio, TV, bank, securities fraud statutes,[4] or any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.[5] An employee need not prove an actual violation of a law, but only that he reasonably believed that his employer was violating securities laws or regulations. As summarized by the ALJ in *Jayaraj v. Pro-Pharmaceuticals, Inc.*:[6]

> **The statute is clear that the Complainant is not required to show that the reported conduct actually constituted a violation of the law, but only that she reasonably believed that the employer violated one of the enumerated statutes or regulations; a belief that an activity was illegal may be reasonable even when subsequent investigation reveals a complainant was wrong.[7]**

Protected Conduct Not Limited to Concerns about Shareholder Fraud

Although the plain language of Section 806 unambiguously protects employees who "provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of . . . *any* rule or regulation of the Securities and Exchange Commission,"[8] there was conflicting authority as to whether protected conduct under SOX is limited to the reporting of concerns about shareholder fraud. In *Grant v. Dominion East Ohio Gas*,[9] the Administrative Law Judge ("ALJ") found that the complainant did not engage in protected activity where none of his expressed concerns "contained any reference to fraud or implication that the company had acted intentionally to mislead shareholders or misstate the company's bottom line." In *Walton v. Nova Info. Systems*,[10] however, the ALJ held that complainant's disclosures to management about deficient internal controls is within the zone of protection afforded by SOX. The ARB resolved this conflicting interpretation by applying the plain meaning of SOX to conclude that protected conduct is not limited to providing information to management about "just fraud, but also [the] 'violation of . . . any rule or regulation of the Securities and Exchange Commission.'"[11] Similarly, a federal judge recently held:

> **If the drafters meant for section 806 to only protect employees who report fraud against shareholders, then they could have easily done so by inserting a comma before "relating to fraud against shareholders." The drafters, however, did not do so. Therefore, the Court finds that reporting alleged violations of mail fraud or wire fraud does not have to relate to shareholder fraud in order to be protected activity under the statute.[12]**

As SOX protects disclosures about what an employee reasonably believes constitutes a violation of *any* rule or regulation of the Securities and Exchange Commission," providing information to management about a wide range of SEC rules designed to prevent fraud constitutes protected conduct. This includes SEC rules requiring publicly-traded companies to maintain adequate internal controls, such as SEC Rule 13a-15(a).[13] Indeed, protecting disclosures about internal controls is critical to effectuating the overall purpose of SOX. As stated in the SEC's rules implementing the Section 404 internal control requirements, "the required evaluation [of internal controls] should help to identify potential weaknesses and deficiencies in advance of a system breakdown, thereby facilitating the continuous, orderly and timely flow of information . . . [i]mproved disclosure may help companies detect fraudulent, financial reporting earlier and perhaps thereby deter financial fraud or minimize its adverse effects."[14] Limiting protected conduct under SOX to actual shareholder fraud would limit the opportunity for companies and shareholders to learn about financial fraud before it is too late.

Degree of Specificity Required

The DOL's ARB has taken a highly formalistic approach to analyzing whether an employee's disclosure is protected under SOX. In *Platone v. FLYi, Inc.*,[15] the ARB held that in order to constitute protected conduct, a complainant's protected communications "must relate 'definitively and specifically' to the subject matter of the particular statute under which protection is afforded."[16] The terms "definitively and specifically," however, do not appear in Section 806, and this heightened burden to establish protected conduct finds no support in the legislative history. To the contrary, Congress intended "to close the loopholes that have allowed for continued offenses in America's corporate community," not to create additional loopholes.[17] Moreover, as a remedial statute, Section 806 of SOX should be construed broadly.[18]

Fortunately, federal courts have generally steered clear of the *Platone* formalistic approach, and do not require SOX complainants to demonstrate that they provided management with a legal memorandum citing the specific SEC rule about which they raised a concern to management. For example, in *Collins v. Beazer Homes, USA, Inc.*,[19] the court held:

> **[T]he mere fact that the severity or specificity of her complaints does not rise to the level of action that would spur Congress to draft legislation does not mean that the legislation it did draft was not meant to protect her. In short, if Congress had intended to limit the protection of Sarbanes Oxley ... or to have required complainants to specifically identify the code section that they believe was being violated, it could have done so. It did not. Congress in-**

stead protected 'employees' and adopted the 'reasonable belief' standard for those who 'blow the whistle on fraud and protect investors.'[20]

In sum, employers should not assume that federal courts will apply the ARB's heightened standard for protected conduct, and instead should assume that employees can engage in protected conduct without citing securities law chapter and verse.

Reasonable Belief

In the most closely-watched SOX case—*Welch v. Cardinal Bankshares Corp*.—the ARB recently issued a surprising interpretation of the "reasonable belief" standard.[21] Prior to the ARB's decision, it was well-established that "a complainant is not required to show an actual violation of the law," but instead "only that she 'reasonably believed' there to be a violation of one of the enumerated laws or regulations."[22]

In *Welch*, the ALJ concluded that the complainant engaged in protected activity when he repeatedly provided information to management about deficient internal controls.[23] More than three years after the ALJ issued this decision, the ARB reversed on the basis that Welch lacked an objectively reasonable basis to believe that Cardinal was violating SEC rules. In their decision, the ARB set forth a new standard for assessing reasonable belief: "Because the analysis for determining whether an employee reasonably believes a practice is unlawful is an objective one, the issue may be resolved as a matter of law."[24] The decision was surprising for at least three reasons.

First, limiting protected disclosures to unequivocal, actual violations of securities laws patently undermines the basic purpose of Section 806, which is to provide an early warning of fraud or internal control deficiencies that could result in shareholder fraud, *before* shareholders have been harmed. As an ALJ noted in *Getman v. Southwest Securities, Inc*.,[25] requiring a SOX complainant to prove an actual violation of law "would require that a whistleblower allow the violation to occur before reporting it. This would defeat the intent of the Act and the whistleblower law in general, which is to prevent the carrying out of the underlying crime." Similarly, the ALJ in *Morefield v. Exelon Services, Inc*.,[26] noted:

The value of the whistleblower resides in his or her insider status. These employees often find themselves uniquely positioned to head off the type of 'manipulations' that have a tendency or capacity to deceive or defraud the public. By blowing the whistle, they may anticipate the deception buried in a draft report or internal document, which if not corrected, could eventually taint the public disclosure. Beyond that, their reasonable concerns may, for example, address the inadequacy of internal controls promulgated in compliance with Sarbanes-Oxley mandates or SEC rules that impact on procedures through out the organization, or the application of accounting principles, or the exposure of incipient problems which, if left unattended, could mature into violations of rules or regulations of the type an audit committee would hope to forestall.[27]

Second, the ARB's construction of "reasonable belief" is contrary to Congressional intent in that the legislative history of Section 806 specifically states that the reasonableness test "is intended to include all good faith and reasonable reporting of fraud, and there should be no presumption that reporting is otherwise, absent specific evidence."[28] Moreover, when Congress chose to include the terms "reasonable belief" in Section 806, it presumably had in mind well-established DOL precedent under analogous whistleblower protection statutes holding that "reasonable belief" is a mixed question of law and fact, and broadly construing "reasonable belief." By redefining "reasonable belief," the ARB has substantially narrowed the scope of protected conduct under SOX.

Third, the ARB concluded that Welch's disclosures about Cardinal's internal controls were not objectively reasonable without engaging in any analysis of the actual SEC internal accounting rules that implement Section 404 of SOX and Section 13 of the Securities Exchange Act of 1934. If reasonable belief is solely an issue of law, then presumably the relevant SEC rules governing internal accounting controls should factor into that analysis. The ARB's *Welch* decision will likely result in ALJs dismissing SOX claims on summary judgment based on an "I know it when I see it" analysis of whether the complainant's alleged protected disclosure sufficiently states an actual violation of an SEC rule.

Fortunately, SOX whistleblowers have fared better in federal court. For example, Judge Charles J. Siragusa of the Western District of New York held in *Smith v. Corning Inc.*[29] that disclosing a violation of generally accepted accounting principles or deficient internal controls can constitute protected conduct under SOX.[30] Similarly, Judge Sterling Johnson, Jr. of the Eastern District of New York held that helping a coworker raise concerns to a company's CEO about incomplete executive compensation disclosures constitutes protected conduct, and that summary judgment should be denied where "a fair and reasonable juror could find that Plaintiff reasonably believed that the company was engaging in accounting practices that needed to be corrected before its financial statements misled shareholders."[31]

Disclosures about Mail and Wire Fraud

In *Platone*, the ARB further narrowed the scope of protected conduct under SOX by holding that where a Section 806 whistleblower complaint is grounded in federal mail and wire fraud statutes, "the alleged fraudulent conduct must at least be of the type that would be adverse to investor's interests."[32] The ARB's only explanation for rewriting this category of protected disclosure is a vague statement in the preamble of SOX that arguably supports a contrary conclusion.[33] Federal courts have not followed this judicial amendment to Section 806. For example, in *Reyna v. Conagra Foods, Inc.*,[34] the court held that "[t]he statute clearly protects an employee against retaliation based upon that employee's reporting of mail fraud or wire fraud regardless of whether that fraud involves a shareholder of the company."

In sum, the ARB's decisions construing the standard for protected conduct under Section 806 have imposed a high bar for complainants, and will likely discourage the types of disclosures that Congress sought to encourage. Federal courts, however, have generally construed protected conduct broadly, and SOX litigation will likely shift to federal courts, thereby diminishing the impact and significance of the ARB's decisions.[35]

Adverse Action

The range of prohibited retaliatory acts under SOX is very broad. The statute specifically prohibits covered companies from "discharg[ing], demot[ing], suspend[ing], threaten[ing], harass[ing] or in any other manner discriminat[ing] against an employee" with respect to the employee's compensation, terms, conditions, or privileges of employment.[36] Under the plain meaning of SOX, a supervisor's threat to terminate an employee in retaliation for the employee engaging in protected conduct constitutes an actionable adverse employment action. The ARB has applied the Supreme Court's *Burlington* standard to SOX claims,[37] under which conduct that "could well dissuade a reasonable worker from making or supporting a charge of discrimination" constitutes actionable retaliation.[38]

SOX Burden-Shifting Framework

To prevail under Section 806, a complainant must prove by a preponderance of the evidence that: (1) he engaged in a protected activity or conduct; (2) the respondent knew that he engaged in the protected activity; (3) he suffered an unfavorable personnel action; and (4) the protected activity was a contributing factor in the unfavorable action.[39]

This burden-shifting framework is very favorable to employees. A contributing factor need not be motivating or substantial, and instead can be "any factor which, alone or in connection with other factors, tends to affect in any way the outcome of the decision."[40] Temporal proximity alone is sufficient to establish an inference of causation.[41] Moreover, if the complainant proves the elements of a Section 806 claim by a preponderance of the evidence, the respondent must demonstrate by clear and convincing evidence that it would have taken the same unfavorable personnel action in the absence of the complainant's protected activity.[42]

Due to the broad range of adverse actions prohibited by Section 806 and the employee-friendly burden of proof, a complainant who can meet the ARB's onerous standard for protected conduct has a good chance of prevailing on the merits. Accordingly, the primary focus of Section 806 litigation will be the employee's protected conduct. If federal circuit courts of appeal continue to reject the ARB's narrow construction of protected conduct under Section 806 and instead apply a standard that is consistent with the plain meaning and intent of the statute, Section 806 might realize its purpose of encouraging employees to improve the accuracy and reliability of corporate disclosures.

Conclusion

A recent article in *Business Week*[43] reports that a survey performed by LRN, an ethics and governance consulting firm, found that although companies have adopted comprehensive codes of ethics and anti-retaliation policies, most employees are reluctant to report misconduct. In particular, the survey found that "73% of full-time American employees reported encountering ethical lapses on the job," but only "one in three . . . reported an incident they believed to be unethical or questionable." Until employees believe that they are protected from retaliation, Section 806 of SOX will not effectuate Congress' intent "to encourage and protect those who report fraudulent activity that can damage innocent investors in publicly traded companies."[44]

NOTES

1 *See* 18 U.S.C. § 1514A. In addition, Congress criminalized retaliation by any person or organization against an individual who has provided truthful information to law enforcement officers concerning the commission of any federal offense. 18 U.S.C. § 1513(e).

2 S. Rep. No. 107-146, as reprinted in 2002 WL 863249 at *19.

3 Richard Moberly, Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win, William & Mary Law Review, Vol. 49, Fall 2007. However, many SOX claims are settled early on because companies often wish to avoid broad discovery about flawed accounting practices or inaccurate financial reporting.

4 *See* 18 U.S.C.A. §§ 1341, 1343, 1344, and 1348.

5 *Taylor v. Wells Fargo Bank, NA,* ARB No. 05-062 at 4, ALJ No. 2004-SOX-43 (ARB June 28, 2007) (citing 18 U.S.C.A. § 1514A(a)).

6 *Jayaraj v. Pro-Pharmaceuticals, Inc.*, 2003-SOX-32 at 16-17 (ALJ Feb. 11, 2005).

7 *Jayaraj*, 2003-SOX-32 at 16-17.

8 18 U.S.C. § 1514A(a) (emphasis added).

9 *Grant v. Dominion East Ohio Gas,* 2004-SOX-63 (ALJ Mar. 10, 2005).

10 *Walton v. Nova Info. Systems*, 2005-SOX-107 (ALJ March 29, 2006).

11 *Klopfenstein v. PCC Flow Techs. Holdings Inc.,* ARB No. 04-149, at 3, 17; see also *Allen v. Stewart Enterprises, Inc.*, ARB No. 06-081, ALJ Nos. 2004-SOX-60 to 62 (ARB July 27, 2006) ("Reporting that a company violated its internal accounting controls may constitute SOX-protected activity.").

12 *Reyna v. Conagra Foods, Inc.,* 2007 WL 1704577, at *16 (M.D. Ga. 2007).

13 *See, e.g., Collins v. Beazer Homes USA, Inc.*, 334 F. Supp. 2d 1365, 21 I.E.R. Cas. (BNA) 1731, 85 Empl. Prac. Dec. (CCH) P 41896, 15 A.L.R. Fed. 2d 769 (N.D. Ga. 2004).

14 Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Release Nos. 33-8238; 34-47986; and IC-26068 (June 5, 2003).

15 *Platone v. FLYi, Inc.,* ARB No. 04-154, ALJ No. 2003-SOX-27, at 17 (ARB Sept. 29, 2006).

16 *Id.* No. 04-154 at 17.

17 Corporate Fraud Accountability Act of 2002 (July 16, 2002), at H4692 (statement of Congresswoman Roukema). *See also* 149 Cong. Rec. S1725-01, S1725, 2003 WL 193278 (Jan. 29, 2003) ("The law was intentionally written to sweep broadly, protecting any employee of a publicly traded company who took such reasonable action to try to protect investors and the market").

18 See, *Mackowiak v. University Nuclear Systems, Inc.,* 735 F.2d 1159 (9th Cir. 1984).

19 *Collins v. Beazer Homes USA, Inc.*, 334 F. Supp. 2d 1365, 21 I.E.R. Cas. (BNA) 1731, 85 Empl. Prac. Dec. (CCH) P 41896, 15 A.L.R. Fed. 2d 769 (N.D. Ga. 2004).

20 *Id.* at 1377 (citations omitted).

21 *See Welch v. Cardinal Bankshares Corp.*, ARB No. 05-064, ALJ No. 2003-SOX-15 (ARB May 31, 2007).

22 *Kalkunte v. DVI Financial Services, Inc.*, 2004-SOX-56 (ALJ July 18, 2005).

23 *Welch*, 2003-SOX-15 (ALJ Jan. 28, 2004).
24 *Welch*, ARB No. 05-064 at 10 (citing *Jordan v. Alternative Resources Corp*., 458 F.3d 332, 339, 98 Fair Empl. Prac. Cas. (BNA) 1400, 88 Empl. Prac. Dec. (CCH) P 42475 (4th Cir. 2006), cert. denied, 127 S. Ct. 2036, 167 L. Ed. 2d 804 (U.S. 2007)).
25 *Getman v. Southwest Securities, Inc*., 2003-SOX-8, at 13 n.8 (DOL Feb. 2, 2004), *reversed on other grounds*, ARB No. 04-059 (ARB July 29, 2005).
26 *Morefield v. Exelon Services, Inc.*, 2004-SOX-2 at 5 (ALJ Jan. 28, 2004).
27 *Id.* at 5.
28 Legislative History of Title VIII of HR 2673: The Sarbanes-Oxley Act of 2002, Cong. Rec. S7418, S7420 (daily ed. July 26, 2002), available at 2002 WL 32054527, citing *Passaic Valley Sewerage Com'rs v. U.S. Dept. of Labor*, 992 F.2d 474, 8 I.E.R. Cas. (BNA) 647, 125 Lab. Cas. (CCH) P 10698, 23 Envtl. L. Rep. 21125 (3d Cir. 1993) (setting forth a broad definition of "good faith" protected disclosures under analogous whistleblower protection statutes).
29 *Smith v. Corning Inc.*, No. 06-CV-6516 CJS (W.D.N.Y. July 9, 2007).
30 Although Congress specifically intended to protect whistleblowers who warn management about the type of accounting chicanery that led to the collapse of Enron, the ARB held in Welch that disclosures about violations of generally accepted accounting practices are not protected under SOX. Welch, ARB No. 05-064 at 11.
31 *Mahony v. KeySpan Corp*., 2007 WL 805813 at *6 (E.D. N.Y. 2007).
32 *Platone*, ARB No. 04-154 at 15.
33 According to the ARB, a reference in the preamble of SOX to "protect[ing] investors" must mean that Congress did not intend to protect from retaliation employee who blow the whistle on mail fraud or wire fraud. *See Platone*, ARB No. 04-154 at 15. As Congress chose to specifically include mail fraud and wire in the categories of protected disclosures in Section 806, it must have assumed that disclosures about mail fraud or wire fraud protect investors. Narrowing the scope of protected conduct based on a vague statement in a preamble does not effectuate Congress' intent. *Id*. at n. 107.
34 *Reyna v. Conagra Foods, Inc.*, 2007 WL 1704577 at *15 (M.D. Ga. 2007).
35 A Section 806 complaint must be filed with the DOL, but if DOL has not issued a final decision within 180 days of the filing of the complaint, the complainant can remove the claim to federal court. 18 U.S.C. § 1514A(b)(1)(B).
36 18 U.S.C. § 1514A(a).
37 *Hirst v. Southeast Airlines, Inc.*, ARB Nos. 04-116, 04-160, ALJ No. 2003-AIR-47(ARB Jan. 31, 2007).
38 *Hirst*, ARB Nos. 04-116, at 10-11, quoting *Burlington Northern and Santa Fe Ry. Co. v. White,* 126 S. Ct. 2405, 2409, 165 L. Ed. 2d 345, 98 Fair Empl. Prac. Cas. (BNA) 385, 87 Empl. Prac. Dec. (CCH) P 42394 (U.S. 2006).
39 49 U.S.C.A. § 42121 (a)-(b)(2)(B) (iii)-(iv); *Taylor v. Wells Fargo Bank, NA*, ARB No. 05-062, ALJ No. 2004-SOX-43, at 4 (ARB June 28, 2007).
40 *Halloum v. Intel Corp.*, 2003-SOX-7 (ALJ Mar. 4, 2004) (*quoting Marano v. Department of Justice*, 2 F.3d 1137, 1140, 8 I.E.R. Cas. (BNA) 1368 (Fed. Cir. 1993)).
41 Bechtel Constr. Co. v. Sec'y of Labor, 50 F. 3d 926, 934 (11th Cir. 1995); Collins, 334 F. Supp 2d at 1379.
42 29 C.F.R. § 1980.104(c).
43 Pallavi Gogoi, The Trouble With Business Ethics, *Business Week*, June 22, 2007.
44 148 Cong. Rec. S7418, 7420 (daily ed. July 26, 2002).

The Fifth Circuit Holds that Loss Causation is a Class Certification Issue

BY WARREN R. STERN & GARRETT B. MORITZ

Warren R. Stern is a partner in the litigation department of the firm of Wachtell, Lipton, Rosen & Katz. Garrett B. Moritz is an attorney associated with that firm. Contact: WRStern@wlrk.com.

In the Fifth Circuit, a district court must now refuse to certify a class in a securities fraud class action unless the plaintiff can prove by a preponderance of the evidence that the alleged misrepresentation caused the class to suffer a loss. If this decision stands and is followed in other Circuits, the law will have moved a long way to reducing the burdens of securities fraud class actions.

In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,[1] the plaintiffs brought a securities fraud class action in the U.S. District

Court for the Northern District of Texas on behalf of purchasers of Allegiance Telecom common stock between April 24, 2001 and February 19, 2002. The plaintiffs alleged that the defendants, who had been Allegiance officers,[2] violated Section 10(b) of the Securities Exchange Act of 1934 by misrepresenting over this ten-month period the number of telecommunications lines installed by Allegiance. The plaintiffs moved for class certification, relying on the presumption of class-wide reliance adopted in *Basic, Inc.* v. *Levinson*.[3] Defendants opposed on the ground that, under Fifth Circuit precedent, the presumption of reliance was rebutted because plaintiffs had not shown that the corrective announcement—as opposed to other adverse developments announced concurrently—caused plaintiffs' loss. The district court granted class certification, holding that rebuttal of the *Basic* presumption was not appropriate on a motion for class certification.[4] The Fifth Circuit granted an interlocutory appeal pursuant to Rule 23(f) of the Federal Rules of Civil Procedure,[5] and vacated the order certifying the class.

The Fifth Circuit, in an opinion by Judge Patrick E. Higginbotham, held that "loss causation must be established at the class certification stage by a preponderance of all admissible evidence."[6] The Court primarily relied on *Greenberg* v. *Crossroads Systems, Inc.*,[7] and *Unger* v. *Amedisys, Inc.*[8] *Greenberg*, an appeal from a grant of summary judgment, held that "to trigger the presumption [of reliance] plaintiffs must demonstrate that . . . the cause of the decline in price is due to the revelation of the truth and not the release of unrelated negative information."[9] *Unger*, an interlocutory appeal from a grant of class certification, held that, on a Rule 23 motion in a fraud-on-the-market case, a district court "must address and weigh factors both for and against market efficiency" and must "find" the facts favoring class certification.[10] *Allegiance Telecom*, the Court said, "lies at the intersection of *Greenberg* and *Unger*," and therefore the district court "erred in ruling that the class certification stage is not the proper time for defendants to rebut lead Plaintiffs' fraud-on-the-market presumption."[11]

The Court dismissed as "outdated" the idea that class certification was merely a provisional procedural step "divorced from the merits of the claim."12 The Court found the idea particularly repugnant in a fraud-on-the-market case where class certification greatly magnified the risks to the defendants:

> **The power of the fraud-on-the-market doctrine is on display here. With proof that these securities were being traded in an efficient market, the district court effectively concluded that if plaintiffs can establish at trial that defendants acted with the requisite intent in counting its installations then defendants would be liable for millions of dollars in paper losses on the day following the fourth-quarter filing date, less the amount the defendant may be able to persuade a jury was caused by other circumstances–whether the purchaser held on and later sold at a higher price or rode the stock down to bankruptcy. In short, the efficient market doctrine facilitates an extraordinary aggregation of claims. We cannot ignore the *in terrorem* power of certification, continuing to abide the practice of withholding until "trial" a merit inquiry central to the certification decision, and failing to insist upon a greater showing of loss causation to sustain certification, at least in the instance of simultaneous disclosure of multiple pieces of negative news.[13]**

The Court found support for its holding in the 1999 amendment to Rule 23(c)(1)(A) requiring a certification ruling only "at an early practicable time" rather than "as soon as practicable," as the Rule formerly required; another amendment to Rule 23 that the Court read to eliminate "conditional" class certification; the Private Securities Litigation Reform Act ("PSLRA"); and decisions in other Circuits holding that issues that overlap with the merits should be decided at the class certification stage if they relate to the requirements of Rule 23.[14]

The Court relied on economic theory to explain why the question of loss causation—typically thought of as a "merits" issue divorced from Rule 23—overlapped with the question of class-wide reliance. The Court explained that, while a market may be efficient (as the market for Allegiance stock clearly was), it may not have efficiently priced the particular alleged misinformation or may have priced the true information due to trading by insiders. "Both explanations," the Fifth Circuit explained, "resist application of the semi-strong efficient-market hypothesis, the theory on which the presumption of class-wide reliance depends."[15] Thus, absent proof of loss causation, the Court could not determine whether the market "relied" on the misrepresentation.

Although the Court had found legal error, it could not vacate the class certification order on that ground alone. The district court, in fact, had weighed the evidence on loss causation and found that "it is more likely than not that a significant part of the stock decline causing the putative Class's loss is attributable to the line count corrective disclosure."[16] The Fifth Circuit, however, held that this finding was "untenable."[17] To show that the price decline was caused in significant part by the corrective disclosure, the plaintiffs had relied on analyst comments lamenting the line count revision and on an expert event study showing that Allegiance's stock price reacted negatively to the "entire bundle" of adverse news.[18] The Court held that this evidence proved market efficiency but not loss causation: "When multiple negative items are announced contemporaneously, mere proximity between the announcement and the stock loss is insufficient to establish loss causation."[19] The Court disavowed requiring either quantification of damages at the class certification stage or event studies, but emphasized that the plaintiffs must "offer some empirically-based showing that the corrective disclosure was more than just present at the scene."[20]

Judge James L. Dennis dissented. He took strong issue with the majority's holding that loss causation must be considered at the class certification stage: "The majority's decision is, in effect, a breathtaking revision of securities class action procedure that eviscerates *Basic*'s fraud-on-the-market presumption, creates a split from other circuits by requiring mini-trials on the merits of cases at the class certification state, and effectively overrules legitimately binding circuit precedents."[21] He also labeled the majority's assessment of the evidence as improper "*de novo*" review.[22] Judge Dennis attacked *Greenberg*'s holding that a fraud-on-the-market plaintiff must show that the market price of the stock actually moved in response to the misrepresentation or the corrective disclosure, and argued that, in any event, *Greenberg* would not require the plaintiffs to prove loss causation as a condition to the presumption of reliance. He accused the majority of substituting its policy views for *stare decisis*[23] and of ignoring *Dura Pharmaceuticals, Inc.* v. *Broudo*,[24] in which the Supreme Court reaffirmed *Basic*. Finally, he accused the majority of disregarding settled procedural limitations by insisting that the district court consider a merits issue in ruling on class certification.

The fate of *Allegiance Telecom* may not yet be determined. Although plaintiffs' petition for rehearing en banc has been denied, the time for seeking certiorari has not passed. But anyone who has ever defended a securities class action case will recognize that putting the plaintiff to its proof on loss causation at the outset of the case may make good sense. Why burden a defendant and the Court with an expensive and complex case when a plaintiff will not be able to carry its burden of proving that the alleged corrective disclosure did not cause its losses? This question will turn entirely on matters of public record and expert testimony; discovery would be superfluous. The *Allegiance Telecom* majority understood this, and their decision reflects the same dry-eyed assessment of the class action device that animated the Class Action Fairness Act of 2005[25] and the recent decision of the Supreme Court in *Bell Atlantic Corp.* v. *Twombly*.[26] One recent commentator has even suggested that *Allegiance Telecom* may "portend[] the wave of the future: early merits-based consideration of plaintiffs' class action complaints."[27]

Of course, *Allegiance Telecom* may be a two-edged sword. If a defendant contests class certification on loss causation grounds and loses, the defendant could be in a worse position than it would have been had the class been certified without consideration of loss causation. In the latter case, the loss causation issue would remain, creating a risk for the plaintiff that the defendant could exploit in settlement negotiations. A defendant with a relatively strong case on liability and a relatively weak case on loss causation may be well-advised to refrain from raising the loss causation argument at the class certification stage. In order to be in a position to make such a judgment, defendants and their counsel should, at the inception of the case, concentrate carefully on the liability issues and work with financial economists to exhaust all possible theories to rebut loss causation and market efficiency.

NOTES

1 *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007).

2 Plaintiffs originally named as defendants Allegiance Telecom, its former chairman and CEO, and a former executive vice president of sales. Allegiance Telecom filed for bankruptcy and was not a party by the time the case reached the Fifth Circuit. *Id.* at 262.

3 *Basic Inc. v. Levinson,* 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988).

4 *See Oscar Private Equity Investments v. Holland*, 2005 WL 877936, at *13 n.17 (N.D. Tex. 2005), order vacated, 487 F.3d 261 (5th Cir. 2007) ("*Basic* held that the presumption of reliance was rebuttable, but only as related to a summary judgment motion. . . . The Court is of the opinion that the class certification stage is not the proper time for Defendants to rebut Lead Plaintiffs' fraud on the market presumption." (citing *Basic*, 485 U.S. at 248)); *id.* at *12 n.16 ("'At [the class certification] stage in the proceedings, the Court need only inquire whether the stock traded in an efficient market and not examine the merits of the case . . . Thus the Court will not address whether Defendants can rebut the presumption of reliance.'" (alterations in original) (quoting *Lehocky v. Tidel Technologies, Inc.*, 220 F.R.D. 491, 505 n.6 (S.D. Tex. 2004))).

5 Federal Rule of Civil Procedure 23(f) provides: "A court of appeals may permit an appeal from an order granting or denying class-action certification under this rule if a petition for permission to appeal is filed with the circuit clerk within 10 days after the order is entered. An appeal does not stay proceedings in the district court unless the district judge or the court of appeals so orders."

6 *Allegiance Telecom*, 487 F.3d at 269.

7 *Greenberg v. Crossroads Systems, Inc.,* 364 F.3d 657, Fed. Sec. L. Rep. (CCH) P 92738 (5th Cir. 2004).

8 *Unger v. Amedisys Inc.*, 401 F.3d 316, Fed. Sec. L. Rep. (CCH) P 93115 (5th Cir. 2005).

9 *Greenberg*, 364 F.3d at 665. *Greenberg* relied on the Fifth Circuit's decision in *Nathenson v. Zonagen Inc.*, 267 F.3d 400, Fed. Sec. L. Rep. (CCH) P 91548 (5th Cir. 2001). In *Nathenson*, the court held that "a fraud-on-the-market theory may not be the basis for recovery in respect to an alleged misrepresentation which does *not* affect the market price of the security in question." *Id.* at 414 (emphasis in original). Thus, in the *Nathenson* court's view, the requirement "that the complained of misrepresentation or omission have actually affected the market price of the stock… relates to reliance." *Id.* at 415.

10 *Unger*, 401 F.3d at 325. *Unger* is consistent with a recent trend toward more rigorous scrutiny of plaintiff's evidence of market efficiency at the class certification stage. *See In re Initial Public Offering Securities Litigation*, 471 F.3d 24, 42, Fed. Sec. L. Rep. (CCH) P 94137 (2d Cir. 2006), decision clarified on denial of reh'g, 483 F.3d 70 (2d Cir. 2007) (reversing district court's class certification decision based on more rigorous scrutiny of plaintiff's evidence of market efficiency); Warren R. Stern & Garrett B. Moritz, *Market Efficiency and Class Certification in Securities Fraud Class Actions*, SEC. LITIG. REP. vol. 3, no. 10 (2006).

11 *Allegiance Telecom*, 487 F.3d at 268-70.

12 *Id.* at 266.

13 *Id.* at 266-67.

14 *Id.* at 267.

15 *Id.* at 269.

16 *Id.* at 270.

17 *Id.*

18 *Id.* at 270-71.

19 *Id.* at 271.

20 *Id.*

21 *Id.* at 272.

22 *Id.*

23 *See id.* at 276 ("Under the majority's approach, *Basic*'s… primary holding is supplanted by extensions of the policy considerations that the majority sees reflected in the enactment of the PSLRA and in recent amendments to Rule 23. . . . Such policy considerations, however, no matter how sincerely interpreted or applied, do not give this court the authority to overrule the Supreme Court's decisions or to change the recognized elements of a Section 10(b) claim, both of which the majority effectively does today.").

24 *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 125 S. Ct. 1627, 161 L. Ed. 2d 577, Blue Sky L. Rep. (CCH) P 74529, Fed. Sec. L. Rep. (CCH) P 93218 (2005).

25 28 U.S.C. § 1711 *et seq.*, Pub. L. 109-2, 119 Stat. 4 (Feb. 18, 2005); *see, e.g.*, S. Rep. 109-14, at 4 (Feb. 28, 2005) ("By now, there should be little debate about the numerous problems with our current class action system.").

26 *Bell Atlantic Corp. v. Twombly,* 127 S. Ct. 1955, 2007-1 Trade Cas. (CCH) P 75709 (U.S. 2007) (abrogating the pleading standard of *Conley* v. *Gibson*, 355 U.S. 41 (1957), because, among other reasons, "[i]t is no answer to say that a claim just shy of a plausible entitlement to relief can, if groundless, be weeded out early in the discovery process through 'careful case management,' given the common lament that the success of judicial supervision in checking [class action] discovery abuse has been on the modest side"); *see also id.* ("[I]t is self-evident that the problem of [class action] discovery abuse cannot be solved by 'careful scrutiny of evidence at the summary judgment stage'... the threat of discovery expense will push cost-conscious defendants to settle even anemic cases before reaching those proceedings.").

27 Sarah S. Gold & Richard L. Spinogatti, *Loss Causation: A New Hurdle for Class Certification*, N.Y.L.J., June 13, 2007, at 3.

Securities Litigation REPORT

West Legalworks
395 Hudson Street, 6th Floor
New York, NY 10014

FIRST CLASS
U.S.POSTAGE
PAID
WEST

Securities Litigation REPORT

West Legalworks
395 Hudson Street, 6th Floor, New York, NY 10014
Phone: 212-337-8444 or 800-308-1700
Fax: 212-337-8445
E-mail: west.legalworksregistration@thomson.com
Web: www.westlegalworks.com

THOMSON
WEST

YES! Rush me ***Securities Litigation Report*** and enter my one-year trial subscription (10 issues) at the price of $498.00. After 30 days, I will honor your invoice or cancel without obligation.

Name ______________________

Company ______________________

Street Address ______________________

City/State/Zip ______________________

Phone ______________________

Fax ______________________

E-mail ______________________

METHOD OF PAYMENT

☐ Check enclosed (to West Legalworks)

☐ BILL ME ☐ VISA ☐ MASTERCARD ☐ AMEX

Account # ______________________

Exp. Date ______________________

Signature ______________________

Postage charged separately. All prices are subject to sales tax where applicable.