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9th Circ. Decision Could Be Game-Changer For Investors

By **Carol Villegas and James Christie** (February 2, 2018, 2:16 PM EST)


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Last Wednesday, the Ninth Circuit issued an important decision in Mineworkers' Pension Scheme et al. v. First Solar Inc. that serves to protect investor rights in securities class actions and will prevent companies that commit fraud from evading liability for their wrongdoing.

In the typical securities fraud case, an investor seeks to recover losses due to the revelation of a fraud that causes a drop in the company's stock price. In order to plead (and ultimately prove) that a company committed securities fraud, plaintiffs must show that the stock drop that caused their losses was related to the fraud perpetrated by the company. For many years, courts in the Ninth Circuit split as to how that causal connection could be shown.

A number of cases in the Ninth Circuit set forth a common-sense approach that would only require plaintiffs to show a "causal connection" between the facts that were misrepresented and the resulting loss. In other words, disclosures about the poor financial health of a company (including missed earnings) that resulted in a stock drop could serve as the basis for a viable loss causation theory — as long as the loss could be traced back to underlying fraud. These cases did not require plaintiffs to show that the defendants affirmatively admitted to the fraud. The reasoning of those cases made sense because companies rarely admit to committing fraud, and oftentimes fail to explain the real reasons for an earnings miss or slowed growth. Thus, the rule set forth in cases such as Nuveen Municipal High Income Opportunity Fund v. City of Alameda,[1] Berson v. Applied Signal Technology Inc.[2] and In re Daou Systems Inc.[3] kept defendants from getting away with fraud, especially in circumstances when they failed to come clean about the fraud itself.

That line of cases stood in sharp contrast to the second line of cases, including Oregon Public Employees Retirement Fund v. Apollo Group Inc.,[4] Loos v. Immersion Corp.,[5] In re Oracle Corp. Securities Litigation[6] and Metzler Investment GMBH v. Corinthian Colleges Inc.[7] Those cases set forth a significantly more restrictive test that would only allow plaintiffs to recover where the market specifically learns of defendants' fraudulent practices. The Metzler line of cases, and the courts applying the rigid test set forth therein, created a significant burden on investors in cases where the defendants either failed to disclose their fraudulent conduct entirely or only revealed the consequences of the fraudulent conduct rather than the conduct itself, i.e. an earnings miss. This line of cases effectively rewarded defendants for continuing to conceal their fraudulent behavior, and frustrated the goals of the federal securities laws — which are meant to protect investors from fraudulent actors.

The First Solar court conclusively sided with investor rights, deciding that a fraud — a tort that is inherently based on deceit and misrepresentation — can be revealed in an "infinite variety" of ways and recognized that defendants should not be able to avoid liability by simply continuing to conceal their fraudulent conduct.

The opinion emphasized that the loss causation analysis in securities fraud cases should focus on traditional tort law principals of proximate cause. Accordingly, the opinion properly focused the relevant inquiry on the underlying facts of the fraud and the defendant's misstatements rather than the disclosure of the fraud itself, "because it is the underlying facts that affect the stock price" and "[f]raud simply causes a delay in the revelation of those facts."

The Ninth Circuit recognized that while disclosure of the fraud helps eliminate other possible causes of the economic loss, the "[d]isclosure of the fraud is not a sine qua non of loss causation, which may be shown even where the alleged fraud is not necessarily revealed prior to the economic loss." Indeed, the opinion explained that the Metzler line of cases setting forth the more restrictive test are simply examples of "fact-specific variants" applying the basic proximate cause test.

The Ninth Circuit's decision to refocus the loss causation analysis on the facts of the underlying fraud makes logical sense. As the court appeared to recognize in its decision, the tort of fraud is inherently based on deceit and misrepresentation. A loss causation test that would require those individuals or corporations that are engaging in deceitful behavior to honestly and fully disclose their fraudulent behavior is simply unrealistic. What is more realistic, and what First Solar seized upon, is that concealed fraudulent behavior could and does manifest itself in a variety of possible ways, including financial harm to the company, regulatory investigations related to the fraudulent conduct, criminal charges, officer and director resignations, and the like.

Going forward, the decision will have far-reaching implications as it applies to pleading and proving loss causation in the Ninth Circuit. First Solar significantly alleviates the burden on plaintiffs to plead (and later show) that the fraud was disclosed to the market, and significantly raises the hurdle for defendants to challenge loss causation at the pleading stage. The decision also provides much-needed clarity regarding the appropriate test for loss causation within the circuit, an element that was regularly contested by defendants at nearly every stage of litigation. While some other circuits still apply a more rigid standard requiring the disclosure of the fraud itself, the Ninth Circuit's First Solar decision represents an important step in the right direction toward protecting the markets and investors from fraudulent behavior and actors.

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[1] 730 F.3d 1111 (9th Cir. 2013).

[2] 527 F.3d 982 (9th Cir. 2008)

[3] 411 F.3d 1006 (9th Cir. 2005)

[4] 774 F.3d 598 (9th Cir. 2014)

[5] 762 F.3d 880 (9th Cir. 2014)

[6] 627 F.3d 376 (9th Cir. 2010)

[7] 540 F.3d 1049 (9th Cir. 2008)