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Loos v. Immersion Corporation: Redefining the Standard in Loss Causation Arguments

Dennise Martinez*

INTRODUCTION

Companies typically conduct internal investigations under a veil of secrecy, withholding information about an investigation until federal or state disclosure requirements mandate disclosure. Company directors and officers fear that a premature admission of wrongdoing will negatively affect the firm’s stock price and expose the firm to liability. Hence, a company has a strong incentive to defer any announcement until it is certain the internal investigation will uncover fraud. The Ninth Circuit’s decision in Loos v. Immersion Corp.1 changes this incentive encouraging companies to announce internal investigations earlier and limiting shareholders’ ability to recover financial losses after such a disclosure. Specifically, in Loos, the Ninth Circuit held that the mere announcement of an internal investigation (preemptive announcement) alone is not enough to plead and prove loss causation—the causal link between a defendant’s misrepresentation and a subsequent financial loss. Loss causation is an essential element of a securities fraud action under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act).2 The court also held that public disclosure of fraud, or corrective disclosure, is a

1. 762 F.3d 880 (9th Cir. 2014).
necessary aspect of proving loss causation. In the same vein, the court affirmed that earnings releases announcing poor financial results are not sufficient in themselves to meet the loss causation requirement.

Although the Loos court correctly maintained that a corrective disclosure is a necessary aspect of proving loss causation, it ultimately erred in not including an announcement of an investigation in that category. To give full effect to the aims of the Exchange Act, which aims to protect and fully compensate the investor for losses from fraud, this Comment argues that courts should presumptively categorize announcements of investigations as corrective disclosures for purposes of pleading loss causation.

Part I of this Comment provides a brief overview of the development of loss causation as an element of proof in a securities action. Part II discusses the court’s reasoning in Loos. Part III.A illustrates that an announcement of an internal investigation is a corrective disclosure because of the market’s reaction, which leads to real financial losses. Part III.B demonstrates that not categorizing an announcement of an investigation as a corrective disclosure conflicts with the intended purpose of the Exchange Act. Finally, Part III.C argues for a rebuttable presumption framework in favor of including announcements of these investigations as corrective disclosures.

I. LEGAL BACKGROUND AND EXISTING LAW

To sustain a securities fraud claim under section 10(b) of the Exchange Act, a plaintiff must show (1) a material misrepresentation or omission, (2) scienter, (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation.\(^3\) Loss causation refers to the causal connection between the material misrepresentation and the loss.\(^4\) A plaintiff can demonstrate this relationship by pointing to a corrective disclosure, an event that discloses the misrepresentation.\(^5\)

In *Dura Pharmaceuticals v. Broudo*,\(^6\) the Supreme Court set the standard for loss causation pleading in a securities fraud action. In brief, the Court held that under section 10(b) of the Exchange Act, a plaintiff must “prove that the defendant’s misrepresentation . . . proximately caused the plaintiff’s economic loss.”\(^7\) Moreover, the only relevant loss is the price drop immediately following a corrective disclosure. In sum, to show loss causation, the plaintiff must plead


\(^4\) *Dura Pharm.*, 544 U.S. at 342.


\(^6\) 544 U.S. 336.

\(^7\) *Id.* at 346.
and prove a causal relationship between public disclosure of the defendant’s fraud and a subsequent drop in stock price.\textsuperscript{8}

Although the \textit{Dura} Court required plaintiffs to link their financial loss to a misrepresentation, it did not precisely identify how loss causation must be pled. Accordingly, the decision has confused lower courts seeking to define the particular contours of what constitutes a corrective disclosure. Notably, in \textit{Meyer v. Greene}, the Eleventh Circuit found that the mere announcement of an SEC investigation “without more, is insufficient to constitute a corrective disclosure.”\textsuperscript{9} Even though the company’s stock price dropped following the announcement of an SEC investigation, the investigation did not confirm that the company misrepresented its previously disclosed financial statements.\textsuperscript{10}

More recently in \textit{Public Employees’ Retirement System v. Amedisys, Inc.}, the Fifth Circuit held that disclosure of a governmental investigation can be relevant to the loss causation inquiry even in the absence of disclosure of actual fraud.\textsuperscript{11} The Fifth Circuit’s decision lays a foundation for other courts wishing to account for an investigation in the loss causation analysis.

II.
The Case

Immersion Corporation (Immersion) is a publicly traded company that develops and licenses “haptics” technology.\textsuperscript{12} The company proved unprofitable for the first six years following its 1999 initial public offering.\textsuperscript{13} It reported its first profitable quarter as a public company in 2007 after settling a patent infringement claim for $150 million.\textsuperscript{14} Aiming to sustain its profitability, Immersion reinvested the funds into new growth initiatives. The company succeeded in the endeavor, achieving profitability in each of the four quarters of 2007.\textsuperscript{15}

Immersion’s profitability ended abruptly in the first quarter of 2008 after it announced a net loss of $2.6 million. The company then reported increasing losses for the subsequent quarters of 2008 as well as the first quarter of 2009.\textsuperscript{16} On July 1, 2009, prior to the stock market’s opening, the company announced that it had launched an internal investigation into its revenue recognition practices. It warned that the investigation might uncover information that “\textit{could} raise issues” with respect to its historical financial information, which

\begin{itemize}
\item \textsuperscript{8} \textit{Id.}
\item \textsuperscript{9} 710 F.3d 1189, 1201 (11th Cir. 2013).
\item \textsuperscript{10} \textit{Id.}
\item \textsuperscript{11} 769 F.3d 313 (5th Cir. 2014) (holding that a series of partial disclosures can establish loss causation even if no single disclosure alone is sufficient).
\item \textsuperscript{12} Haptic technology allows electronic devices to produce tactile feedback to users.
\item \textsuperscript{13} Loos v. Immersion Corp., 762 F.3d 880, 884 (9th Cir. 2014).
\item \textsuperscript{14} \textit{Id.} at 884.
\item \textsuperscript{15} \textit{Id.}
\item \textsuperscript{16} \textit{Id.} at 884–85.
\end{itemize}
“could be material.” The company’s stock price dropped over 23 percent on this news.\textsuperscript{18}

One month later on August 10, 2009, Immersion officially advised investors that its prior financial statements were unreliable due to errors in its revenue recognition practices.\textsuperscript{19} Essentially, the company recognized sales revenue prematurely, leading to a restatement of its earnings from years 2006 to 2008 as well as the first quarter of 2009.\textsuperscript{20}

The shareholder plaintiffs brought suit in a series of shareholder class actions, claiming that Immersion had made false and misleading statements about its financial condition in violation of section 10(b) of the Exchange Act. In an attempt to prove “loss causation,” plaintiffs stressed various purported “corrective disclosures” made by Immersion consisting of: (1) earnings releases announcing financial results that fell short of market expectations; and (2) the July 1, 2009, announcement of an internal investigation into its revenue recognition practices.\textsuperscript{21} The company’s stock price fell on the heels of each of these disclosures, causing financial losses to investors. Nevertheless, the court found that these facts were not enough to show loss causation. The district court dismissed the case with prejudice on December 16, 2011.\textsuperscript{22}

The Ninth Circuit affirmed the district court’s decision, agreeing that the mere announcement of disappointing earnings does not “reveal any information from which revenue accounting fraud might reasonably be inferred,” and thus could not support a finding of loss causation.\textsuperscript{23} Following precedent in Metzler Investment GMBH v. Corinthia Colleges, Inc.,\textsuperscript{24} the court required the plaintiff to show that the market had “learned of and reacted to” the actual fraud, not mere reports of the “defendant’s poor financial health.”\textsuperscript{25} Because the announcement of an internal investigation does not itself “reveal” fraudulent practices to the market,” the court concluded that it is not enough by itself to prove loss causation.\textsuperscript{26} In so ruling, the Ninth Circuit agreed with the Eleventh Circuit’s reasoning in Meyer v. Greene, which held that the company’s disclosure of an SEC informal inquiry and subsequent private investigation was not a corrective disclosure for purposes of loss causation because it did not reveal actual fraud.\textsuperscript{27}

\textsuperscript{17} Id. (emphasis added).
\textsuperscript{18} Id. at 885.
\textsuperscript{19} Id. at 885–86.
\textsuperscript{20} Id. at 886.
\textsuperscript{21} Id. at 887.
\textsuperscript{22} Id. at 883–84.
\textsuperscript{23} Id. at 888.
\textsuperscript{24} 540 F.3d 1049 (9th Cir. 2008).
\textsuperscript{25} Id. at 1063; see also In re Oracle Sec. Litig., 627 F.3d 376, 392 (9th Cir. 2010); In re Omnicom Grp., Inc. Sec. Litig., 541 F. Supp. 2d 546 (S.D.N.Y. 2008), aff’d, 597 F.3d 501 (2d Cir. 2010).
\textsuperscript{26} Loos, 762 F.3d at 890.
\textsuperscript{27} See 710 F.3d 1189, 1201 (11th Cir. 2013).
III.
A REBUTTABLE PRESUMPTION FOR THE CORRECTIVE DISCLOSURE

Although the Ninth Circuit correctly held that plaintiffs must prove loss causation to plead a section 10(b) fraud action, the court failed to categorize announcements of investigations into the company, preemptive announcements, as corrective disclosures. This Part argues that courts should treat preemptive announcements as corrective disclosures because they reveal information subject to stock price reaction. Moreover, not doing so severely limits a plaintiff’s recovery once a company ultimately reveals its fraud. I conclude by proposing a framework for a rebuttable presumption that would broaden the definition of corrective disclosures to include preemptive announcements.

A. An Announcement of an Investigation Preemptively Discloses Wrongdoing

Loos embraces the notion that only news that explicitly affirms a company’s prior misstatements can be a catalyst for a drop in a company’s stock price. That is, it asserts that the market will only react to confirmed news of wrongdoing within a company. This view of the market is oversimplified. In reality, markets quickly adjust a company’s stock price to reflect all publicly available information about the company. 28

Investors are aware of a company’s wrongdoing even before the company explicitly affirms its previous false disclosure. Indeed, investors have historical information, trends, and a plethora of other information readily available. Shrewd investors understand that, given the possible repercussions, both management and boards of directors are loath to begin an internal investigation due to the negative repercussions that might result. 29 They are also aware that a company’s officers and directors consider the legal implications and practical impact of disclosing or not disclosing formal inquiries into its past public disclosures. 30 For example, officers and directors are acutely aware that typically the company’s stock price drops after the announcement of an investigation into its practices. 31

Thus, management’s fears, coupled with a limited duty to disclose such investigations, means companies will only disclose when absolutely necessary. In most cases, companies are likely to proactively disclose only when they believe there is a high probability of material misstatement. For instance, although a company is not required to disclose the existence of an ongoing government investigation—such as an SEC investigation—a duty of disclosure may arise with respect to “material information.” Material information can include an event uncovered during an investigation that is “substantially certain,” and likely to change the investor’s perceived value of the investments. Nonetheless, there is “no statute, regulation, or rule” that creates a duty on companies to disclose an ongoing internal government investigation.

With this background in mind, it is near certain that a sophisticated investor would have known that Immersion’s preemptive announcement signaled at least a high probability or “substantial certainty” that a material misstatement exists. Even without complete certainty, the court should have attributed some portion of the decline in stock price after the announcement to an expected future disclosure of revised public statements. In fact, from 2007 to 2009, the SEC brought suit in 76 percent of the 2,610 instances in which the agency commenced an internal investigation; 82 percent of those suits alleged fraud or market manipulation. This indicates that in a majority of the cases it investigates, the SEC finds enough to warrant a formal enforcement action against the company. Moreover, one study of SEC investigations from 2001 to 2003 found that a company’s stock price dropped approximately 8 percent after a company announced an SEC investigation compared to an initial drop of 29 percent following the market’s initial discovery of fraud. These statistics suggest that the market incorporates the high potential for financial fraud into its assessment of the firm’s value even before the SEC begins a formal investigation.

33. Id. at 973; see also Herb Greenberg, Why do Investors Ignore Inquiries?, WALL ST. J. (Apr. 12, 2008, 12:01 AM), http://www.wsj.com/articles/SB120796261950109637.
34. Indeed, one study shows that the stock price of a “company subject to investigation tends to fall an average of 40 percent from the first ‘revelation of misconduct’ until the investigation is resolved, suggesting that the market may view the existence of a government investigation as material information.” See Stuart & Wilson, supra note 32, at 975 n.9.
36. Theodore E. Christensen et al., Market Efficiency and Investor Reactions to SEC Fraud Investigations, 2 J. FORENSIC & INVESTIGATIVE ACCT. 1, 3, 26–27 (2010). The authors describe the initial discovery of fraud as the “market discovery date.” Id. at 2. This is the date that a “public news announcement becomes available regarding the alleged fraud.” Id.
37. See id.; see also MARK S. BEASLEY ET AL., COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM., FRAUDULENT FINANCIAL REPORTING, 1998-2007: AN ANALYSIS OF U.S.
Therefore it is incorrect to assume, as the Loos and Meyer courts did, that plaintiffs can show loss causation only by pointing to an affirmative disclosure of fraud.\(^{38}\) The court should factor in any corrective disclosure—or suggestion of fraud—that causes a drop in share price. A knowing investor who understands the connection between stock value and stock price and the relative infrequency of investigation disclosures will perceive the preemptive announcement as if it were an actual disclosure of fraud. Thus, preemptive announcements often function as de facto corrective disclosures.

B. Eliminating or Diminishing Losses Recoverable

Not categorizing a preemptive announcement as a corrective disclosure essentially permits management to avoid liability for fraud with strategic timing. By bundling disclosures and timing the release of negative news, such as the beginning of an internal investigation, company management can conceal the causal link between a share price decline and the purported fraud.\(^{39}\) The court in In re Apollo Group, Inc. Securities Litigation warned of such possibility: “[I]t would give companies the perverse incentive to indulge in opaque, piecemeal disclosures, specifically designed to avoid any market reaction to the news.”\(^{40}\) This type of bundling vastly limits an investor’s rightful recovery.

Under Loos, a company has a strong incentive to inform the public of its own internal investigation to minimize liability for financial losses.\(^{41}\) The moment management and directors become aware of potential (or actual) liability for misreporting prior statements, the company may issue a “warning,” announcing the beginning of an investigation. The company benefits from making the warning as dire as possible.\(^{42}\) It will claim that it is conducting a

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38. See Loos v. Immersion Corp., 762 F.3d 880, 890 (9th Cir. 2014); Meyer v. Greene, 710 F.3d 1189, 1201 (11th Cir. 2013).
41. See infra notes 43–48 and accompanying text.
42. Presumably, stock prices will drop lower proportional to the direness of the warning.
“full and extensive” investigation, but has not reached a conclusion as to whether any fraud has actually been discovered.

Although the stock price will undoubtedly fall following such an announcement, a company cannot be held liable under Loos. This would hold true even if the company deliberately engaged in fraud. This happens because investors quickly react to the release of significant, new information and the market impounds that reaction into the stock’s price. As described in Part III.A, a preemptive announcement can cause a drop in stock price. Yet an SEC investigation typically takes twenty-three months from beginning to end. During this period, the market will not only absorb investors’ assessment of the high potential for fraud, but will respond to interim information that might drive the price of the company’s stock up. Thus, if the investigation ultimately reveals actual fraud two years later, the announcement of the actual fraud might have little effect on price, leading to a slight fall or even a rise if the market expected the finding to be worse. Under Loos’s strict interpretation of corrective disclosures, this lack of an “economic loss” can preclude a court from finding loss causation. Essentially, the court would be precluded from tracing the loss back to the preemptive announcement and calculating damages from the point when the company disclosed actual fraud. Even if such a result does not completely bar the amount recoverable by investors, it at least vastly reduces it.

If loss causation is to be given any credence, it must include that portion of the price drop attributable to the preemptive announcement. This calculation would be more reflective of the realities of market speculation, which incorporates not only future earnings projections but also imminent

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44. Assuming a semi-strong form of market efficiency, a company’s stock price reflects the information contained not only in past prices but all public information. See Christensen, supra note 36, at 2.

45. See id.

46. See id.

47. See Eisenhofer et al., supra note 39, at 1443–44; see also John McDowell, A Look at the Market’s Reaction to the Announcements of SEC Investigations 14 (Apr. 1, 2005) (unpublished manuscript), available at http://web-docs.stern.nyu.edu/glucksman/docs/McDowell_2005.pdf (explaining that a stock’s value underperforms the market for three months after a preemptive announcement, but eventually regresses toward the mean with stocks in investigation portfolios outperforming the market).

48. Though treated as independent elements in a fraud case, economic loss and loss causation are inextricably linked: a plaintiff must have suffered economic loss before claiming that the fraud was the proximate cause of that loss. Courts calculate economic loss in fraud cases by measuring “out of pocket” damages or the difference between the purchase price and the true value of the stock—the “price at which the stock would have sold absent the alleged misrepresentations or omissions.” Eisenhofer et al., supra note 39, at 1424–25.

49. See id. A company stock’s worth is equal to the present value of all of its estimated future cash flows. Id.
reveals of corporate misconduct. Thus, to the extent that an investigation
does reveal the existence of fraud, any stock price drop resulting from the
announcement of the investigation should be included in the determination of
investor losses.

C. Rebuttable Presumption Framework

To give effect to the Exchange Act’s goal of investor protection, this
Comment proposes a new rebuttable presumption framework that broadens the
category of corrective disclosures to include preemptive announcements. This
framework would have courts factor in any drop in stock price following an
announcement of an investigation when calculating plaintiff’s losses. Assuming plaintiff can meet the other elements of a fraud action, it would hold
a company presumptively liable for the initial drop in stock price. The
company could rebut that presumption by showing that the investigation did
not result in the discovery of a material misstatement or omission.

Shifting the burden of proof from the investor plaintiff to the company
defendant is not only logical but fair. The company has easier access to
information and imputed knowledge of the misrepresented facts. Burden
shifting does not place an undue burden on the company because the law
already requires companies to undertake an investigation and reveal their
findings. Neither would such a standard have a chilling effect on a company’s
willingness to preemptively disclose their investigations. After all, even under
this framework, a company could disclose to distort the causal link between a
fraudulent misrepresentation and a subsequent drop in price.50

Adopting this corrective disclosure approach would lessen the burden on
plaintiffs without placing undue burden on the defendant company. Indeed,
even the Ninth Circuit recognized that a decline in stock price after a
preemptive announcement is attributable to the market speculating as to what
the investigation will reveal.51 If the investigation ultimately reveals
wrongdoing, this framework will compensate the market for its accurate
“speculation.”52

CONCLUSION

Securities lawsuits are frequently filed after a company announces an
internal or government investigation but before any official announcement of
wrongdoing. In Loos, the Ninth Circuit joined the Eleventh Circuit in rejecting
the notion that such announcements can satisfy the loss causation requirement
for a securities fraud action. The decision effectively strengthened the defenses
against such actions at the pleading stage and unnecessarily limited the amount

50. See supra Part III.B; Loos v. Immersion Corp., 762 F.3d 880, 890 (9th Cir. 2014).
51. Loos, 762 F.3d at 890.
52. See id.
that investors can recover from actual fraud. Thus, treating preemptive announcements as corrective disclosures for purposes of establishing loss causation will not only remove a major hurdle for investor plaintiffs, but also remedy the harms that the Exchange Act seeks to address.