



The Ninth Circuit Tightens the Screws on Plaintiffs' Burden to Allege "Loss Causation" when a Corporation Announces an Internal Investigation

BY [SECURITIES LITIGATION PRACTICE GROUP](#)

On August 7, 2014, the Ninth Circuit issued its decision in *Loos v. Immersion Corporation*, addressing for the first time whether a company's announcement of an internal investigation into fraud is, alone, sufficient to establish "loss causation" for claims under the federal securities laws.¹ The Court held that the mere announcement of an investigation was not sufficient to plead loss causation.² The decision in *Loos* solidifies defendants' position that the disclosure of a "risk" or "potential" for fraud cannot stand as the revelation of fraud to support loss causation arguments at the pleadings stage.

***Dura Pharmaceuticals*: Defining the Standard for Loss Causation**

In order to establish a claim for fraud under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, a plaintiff must prove six elements: (1) material misrepresentation; (2) scienter; (3) connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation.³ The sixth and final element—loss causation—was at issue in *Loos*. In *Dura Pharmaceuticals v. Broudo*, the Supreme Court set the standard for adequately alleging and proving loss causation. In short, a plaintiff must "prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss."⁴ It is not enough for a misrepresentation to "'touch upon' a loss."⁵ Moreover, as the Supreme Court emphasized in *Dura Pharmaceuticals*, to adequately allege loss causation, a plaintiff may not simply claim that he purchased the defendant's stock at a price inflated by the misrepresentation.⁶ Rather, the plaintiff must demonstrate that public disclosure of the defendant's prior misrepresentation caused the plaintiff's concrete financial loss.⁷

***Loos*: Internal Investigations and Loss Causation**

The fact pattern in *Loos* is not uncommon in corporate America. Immersion Corporation ("Immersion") was a publicly-traded company whose reported financial health seesawed during 2007 and 2008. After years of unprofitability, Immersion strung together four profitable quarters in 2007.⁸ However, the tide soon turned and, in 2008, Immersion posted a net loss for all four quarters.⁹ Immersion also incurred a net loss for the first quarter of 2009.¹⁰ On July 1, 2009, the company publicly announced that it was undertaking an internal investigation into certain of its revenue recognition practices.¹¹ While Immersion cautioned that the investigation may reveal information which "could raise issues with respect to its previously-reported financial information," the company was unable to fully

evaluate the investigation prior to its completion.¹² The day of the announcement, the price of Immersion's shares declined 23%.¹³ On August 10, 2009, Immersion revealed that its prior financial statements were no longer reliable and that it would restate its 2008 financial results.¹⁴ No significant stock price movement is alleged to have occurred on that announcement. Finally, on February 8, 2010, Immersion disclosed the results of its internal investigation and restated its prior earnings.¹⁵ Again, no significant stock price movement is alleged to have occurred on that disclosure.

The plaintiff's first complaint against Immersion was dismissed, with leave to amend, because the plaintiff failed to adequately plead loss causation (and scienter).¹⁶ On the plaintiff's second bite at the apple, the district court again dismissed the claim on the exact same grounds.¹⁷ On appeal, the plaintiff argued that the steep drop in Immersion's shares following the July 1, 2009 announcement of the internal investigation demonstrated loss causation.¹⁸ According to the plaintiff, the company's disappointing earnings results during 2008 and the first quarter of 2009 were "partial" revelations of the fraud, with the complete revelation occurring at the time the internal investigation was announced on July 1, 2009.¹⁹

The Court in *Loos* rejected this argument, noting first that, in order to properly plead loss causation, the plaintiff must demonstrate that the alleged fraud was disclosed to the market and caused the plaintiff's resulting loss.²⁰ Immersion's poor financial results during portions of 2008 and 2009 were not sufficiently suggestive of underlying accounting fraud.²¹ The Court also found that "any decline in a corporation's share price following the announcement of an investigation [on July 1, 2009] can only be attributed to *market speculation* about whether fraud [] occurred."²² Noting that *Dura Pharmaceuticals* and Ninth Circuit precedent require more than the revelation of "risk" or "potential" for widespread fraudulent conduct, the Court in *Loos* held that "the announcement of an investigation, without more, is insufficient to establish loss causation."²³

Despite this ruling, *Loos* leaves a number of important questions unanswered. First, there are questions of disclosure—*when* a company should announce the commencement of an internal investigation and *what* information should the announcement include. There may be instances in which a company may commence an investigation at such time as there are certain indicia of fraud, but arguably no conclusive proof of fraud. The scope and nature of appropriate disclosures in such circumstances is not an easy question and will require consultation with experienced counsel.

Second, while the *Loos* opinion is certainly helpful for securities fraud defendants, securities litigators will continue to wrestle with the significance of disclosures regarding internal investigations. Interestingly, the Court in *Loos* acknowledged that the disclosure of an internal investigation can *potentially* be relevant to loss causation,²⁴ but standing on its own, the disclosure was insufficient as a revelation of the fraud. So, there could potentially be instances in which the announcement of an investigation occurs in a context different from that in *Loos* and in which plaintiffs press loss causation arguments arising from the announcement of an investigation. Further, because *Loos* was decided on a motion to dismiss at the pleading stage, it is likely that plaintiffs' counsel will attempt to plead around the Court's holding in order to get past the automatic stay of discovery under the Private Securities Litigation Reform Act.

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¹ No. 12-15100, --- F.3d ---, 2014 WL 3866084 (9th Cir. Aug. 7, 2014).

² *Id.* at *1.

³ *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341 (2005).

⁴ *Id.* at 346.

⁵ *Id.* at 343.

⁶ *Id.* at 347.

⁷ *See id.* at 346-48.

⁸ 2014 WL 3866084, at *2.

⁹ *Id.* at *2-3.

¹⁰ *Id.*

¹¹ *Id.* at *3.

¹² *Id.*

¹³ *Id.* at *4.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.* at *1.

¹⁷ *Id.* at *1-2.

¹⁸ *See Id.* at *1.

¹⁹ *See Id.* at *5-6.

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²⁰ *Id.* at *5.

²¹ *Id.* at *6.

²² *Id.* at *8 (emphasis added). In discussing Immersion's July 1, 2009 announcement of an internal investigation, the Court noted that "[w]e have never squarely addressed whether the disclosure of an internal investigation can satisfy the loss causation element of a § 10(b) and Rule 10b-5 claim." *Id.* at *7. Although conceding that "the announcement of an investigation can *potentially* be relevant to . . . loss causation," the Court recognized that prior Ninth Circuit cases are not particularly instructive to the question raised in *Loos*. *Id.* Accordingly, the Court turned to an Eleventh Circuit case, *Meyer v. Greene*, which held that "the commencement of an SEC investigation, without more, is insufficient to constitute a corrective disclosure for purposes of § 10(b)." *Id.* at *7-8 (quoting *Meyer v. Greene*, 710 F.3d 1189, 1201 (11th Cir. 2013)). The Court in *Loos* agreed with the Eleventh Circuit's approach in *Meyer*.

²³ *Id.* at *7-8. Interestingly, the plaintiff also argued that Immersion's disclosures on August 10, 2009 (that its financial statements were not reliable) and February 8, 2010 (that the investigation concluded, and restating its earnings) confirmed the market's fears arising after the July 1, 2009 disclosure of the investigation. According to the plaintiff, these later revelations affirmed the "'causative link' between the fraud and his loss." *Id.* at *8. The Court rejected this argument because the plaintiff failed to plead the effect of these later disclosures on the price of Immersion shares. *Id.*

²⁴ *Id.* at *7.