

Winter 1-1-2006

Avoiding Blurred Lines: The Computation of Damages in Rule 10B-5 Securities Class Action Lawsuits in the Ninth Circuit and a Proposal for a More Sensible System

Jeffrey M. Goldman

Follow this and additional works at: https://repository.uchastings.edu/hastings_business_law_journal



Part of the [Business Organizations Law Commons](#)

Recommended Citation

Jeffrey M. Goldman, *Avoiding Blurred Lines: The Computation of Damages in Rule 10B-5 Securities Class Action Lawsuits in the Ninth Circuit and a Proposal for a More Sensible System*, 2 *Hastings Bus. L.J.* 261 (2006).

Available at: https://repository.uchastings.edu/hastings_business_law_journal/vol2/iss1/6

This Article is brought to you for free and open access by the Law Journals at UC Hastings Scholarship Repository. It has been accepted for inclusion in *Hastings Business Law Journal* by an authorized editor of UC Hastings Scholarship Repository. For more information, please contact wangangela@uchastings.edu.

AVOIDING BLURRED LINES: THE COMPUTATION OF DAMAGES IN RULE 10B-5 SECURITIES CLASS ACTION LAWSUITS IN THE NINTH CIRCUIT AND A PROPOSAL FOR A MORE SENSIBLE SYSTEM

*Jeffrey M. Goldman**

I. INTRODUCTION

When plaintiffs bring a federal class action lawsuit against one or more defendants for violations of Rule 10b-5 of the Securities and Exchange Act of 1934 (“Rule 10b-5”), one of the most difficult issues that arises is the damages prove-up.¹ This certainly presented a challenge in the 2004

* B.A., University of Wisconsin-Madison; J.D., UCLA School of Law, *Order of the Coif*. Mr. Goldman is currently a litigation associate in the Los Angeles office of Milbank, Tweed, Hadley & McCloy.

1. Enacted in 1948, and amended in 1951, Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a. To employ any device, scheme, or artifice to defraud,

b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

15 U.S.C. §78j(b) (2005).

Northern District of California case of *In re Clarent Corp.*,² the third-ever Rule 10b-5 securities class action to go to verdict since the enactment of the Private Securities Litigation Reform Act of 1995 (the “PSLRA”).³ Although litigants can spend thousands of dollars on highly qualified experts to prove damages, the fact remains that the computation of damages is rarely more than an optimistic estimate based on vague, complex, and difficult-to-ascertain factors. Given that PSLRA made it more difficult to plead Rule 10b-5-related fraud than before, it may strike attorneys as odd that the legislature has not correspondingly made it more difficult for “professional plaintiffs” to present difficult-to-understand damages estimates to the jury.⁴ Furthermore, given that the trend seems to be that more and more Rule 10b-5 cases will be brought in this era of

2. No. C-01-3361 CRB (N.D. Cal.).

3. The author wishes to note that what he was on the litigation team that represented the defendant in *In re Clarent Sec. Litig.* (though the case went through to verdict, it was settled prior to the damages phase). Along the way, the difficulty of establishing damages was but one of the fascinating areas of undeveloped law that demonstrated a need for attention in the academic world. This is probably due to the fact that so few claims go to trial; “it has been estimated that more than 80% of all class action securities law claims are settled, between 10% and 20% are dismissed by the court and far less than 1% go to trial.” Paul W. Boltz, Jack C. Auspitz & Charles C. Corney, *Securities Class Action Litigation in the U.S.: What Asian Issuers Need to Know*, (2004), <http://library.findlaw.com/2004/Aug/23/133555.html>.

It should also be noted that this article, for the most part, discusses the assessment of damages in securities class action cases where there has only been one actionable misstatement by a Defendant. The author recognizes that in many class action securities cases, plaintiffs will have alleged several misstatements over numerous financial quarters – often with a differing number of misstatements for each quarter. While I have tried my best to keep this article’s analysis at a basic level, the fact that plaintiffs often allege several misstatements over several quarters simply lends credence to this paper’s thesis, which is that it is extraordinarily difficult, if not impossible, to accurately assess damages in class action securities cases.

4. See Private Securities Litigation Reform Act of 1995 §27(a)(3)(B)(vi), 15 U.S.C. § 77z-1(a)(3)(B)(vi) (2005) (restricting “professional plaintiffs” by limiting lead plaintiffs in securities class actions to one who has served as a “lead plaintiff, or an officer, director, or fiduciary of a lead plaintiff, in no more than 5 securities class actions brought as plaintiff class actions pursuant to the Federal Rules of Civil Procedure during any 3-year period”); Fed. R. Civ. P. 9(b) (“In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally”). See also Securities and Exchange Act of 1934 § 21D(b), 15 U.S.C. § 78u-4 (2005) (generally requiring a plaintiff to specifically plead each alleged misrepresentation or nondisclosure and why it is misleading, and mandating specific allegations of facts as to any disclosure deficiency supporting a “strong inference” that the defendant knew that the given misstatement or omission was false).

corporate scandal, securities litigators must familiarize themselves with all undeveloped aspects of related law.

This paper first gives a brief explanation of Rule 10b-5. Then, the paper explains both how damages are determined by Ninth Circuit federal courts in Rule 10b-5 actions, and certain corresponding admissibility standards that must be met in an expert's report valuating damages in Rule 10b-5 cases. Then, given the premise that one cannot prove, with requisite certainty, the damages suffered by a class when a defendant violates Rule 10b-5, this paper argues for the establishment of statutory fines as damages, as opposed to requiring the defendant to pay the amount of money lost due to his, her, or its fraudulent activities.

II. RULE 10B-5'S ELEMENTS

Under Rule 10b-5, private litigants have an "implied remedy" by which they can sue "primary violators" of the federal securities laws.⁵ Although this article presupposes a general basic knowledge of Rule 10b-5, the basic elements of such a claim are described in this section.

First, there must be the employment of deceptive devices or contrivances by a defendant seeking to commit fraud with respect to the sale or purchase of securities.⁶ Second, a plaintiff must be either a purchaser or seller of securities.⁷ Third, the plaintiff must prove that the defendant engaged in "manipulation" or "deception," and not just breach of fiduciary duty.⁸ Fourth, the plaintiff must demonstrate that the defendant's misstatement or nondisclosure is material.⁹ Fifth, the defendant must act with scienter, meaning knowing or intentional misconduct.¹⁰ Sixth, the defendant must prove that he relied on the alleged representation after exercising due diligence, and establish causation between the defendant's wrongful conduct and the plaintiff's loss by virtue of purchasing or selling

5. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983).

6. *Loveridge v. Dreagoux*, 678 F.2d 870, 874 (10th Cir. 1982).

7. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1977); *McGann v. Ernst & Young*, 102 F.3d 390 (9th Cir. 1996).

8. *See, Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

9. *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) and stating that "[t]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.").

10. *See Aaron v. SEC*, 446 U.S. 680 (1980).

a security.¹¹ Indeed, a plaintiff can only have standing if the plaintiff has purchased or sold securities.¹² Seventh, when liability is based upon silence, the alleged violator must have had a duty to disclose the withheld information.¹³ Eighth, and as with almost any cause of action, the plaintiff must prove the extent of the damages suffered.

Although several topics arise surrounding these basic elements, this paper focuses on the extraordinarily difficult nature of computing damages suffered by a large class of shareholders over an extended time period.

III. PLAINTIFFS IN A CLASS ACTION SUIT FOR VIOLATION OF RULE 10B-5 CAN RECOVER ACTUAL, OUT-OF-POCKET DAMAGES, AND IN CERTAIN CIRCUMSTANCES CAN RECOVER CONSEQUENTIAL DAMAGES

In actions for a violation of Rule 10b-5, Plaintiffs are limited in their potential recovery to actual, out-of-pocket damages, as “no person permitted to maintain a suit for damages under the provisions of [the Securities and Exchange Act of 1934] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.”¹⁴ Consequently, Plaintiffs in this action can only receive actual, out-of-pocket damages pursuant to statute.¹⁵

11. *Levinson*, 485 U.S. at 224. See also Securities and Exchange Act of 1934 § 21D(b), 15 U.S.C. § 78u-4 (2005) (providing that plaintiff must prove loss causation in any private action arising under the Securities and Exchange Act of 1934); C. Edward Fletcher, *The “In Connection With” Requirement of Rule 10b-5*, 16 PEPP. L. REV. 913 (1989).

12. *Blue Chip Stamps*, 421 U.S. at 733-61.

13. *Chiarella v. United States*, 445 U.S. 222 (1980).

14. Securities Exchange Act of 1934 §28(a), 15 U.S.C. § 78bb(a) (2004).

15. *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1181 (9th Cir. 1993) (citing *Arrington v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 621 (9th Cir. 1981)). See also *Affiliated Ute Citizens of the State of Utah v. United States*, 406 U.S. 128, 154-55 (1972) (holding that damages in a securities fraud case are measured by the difference between the price at which a stock sold and the price at which the stock would have sold absent the alleged misrepresentations or omissions); *Ambassador Hotel Co., Ltd. v. Wei-Chuan Inc.*, 189 F.3d 1017, 1030 (9th Cir. 1999) (holding that the usual measure of damages for Rule 10b-5 violations is out-of-pocket loss, which is the difference between the values of what the plaintiff gave up and the value of what the plaintiff received); *DCD Programs, Ltd. v. Leighton*, 90 F.3d 1442, 1447 (9th Cir. 1996) (holding that compensatory damages in securities fraud actions focus on the “plaintiff’s actual loss, rather than on his potential gain”).

Actual damages are the plaintiffs' loss as represented by the decline in stock value attributable to alleged Rule 10b-5 violations.¹⁶ Where a class

seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.¹⁷

Also, the plaintiffs may be able to receive "consequential damages that can be proven with reasonable certainty to have resulted from the fraud."¹⁸

IV. DETERMINING ACTUAL DAMAGES IN THE NINTH CIRCUIT THROUGH THE "PRICE LINE" AND "VALUE LINE" METHOD SET FORTH IN GREEN V. OCCIDENTAL PETROLEUM CORP.

It is important for both litigants and their attorneys in the Ninth Circuit to have a firm grasp as to how damages will be estimated in Rule 10b-5 cases, as well as in related securities actions. Otherwise, the opposition's expert cannot be adequately cross-examined, and the jury will likely be left with two disparate damages estimations, both created by typically well-credentialed and credible experts. Furthermore, given the large number of technology companies in California that went bankrupt following the dot-com bust, resulting in a high likelihood of shareholder-instigated securities class action lawsuits, Ninth Circuit attorneys have a high professional impetus to know about damages estimations in such cases. Not only is such knowledge important at trial, but given that the vast majority of these claims are dismissed or settled, attorneys need to know the true value of a claim.¹⁹

16. *In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1347-50 (9th Cir. 1994); *see also In re Oracle*, 829 F. Supp. at 1181 (adopting the "efficient capital market hypothesis," and holding that damages must account for all factors affecting a stock's price because a "security's value does not fluctuate with reported earnings, but varies instead with the discounted value of future cash flows which are expected to accrue to the security. For a variety of reasons, these may not reflect reported earnings.")

17. Securities Exchange Act of 1934 §21D(e)(1), 15 U.S.C. § 78u-4(e) (2004).

18. *DCD Programs, Ltd.*, 90 F.3d at 1447 (quoting *Volk v. D.A. Davidson & Co.*, 816 F.2d 1406, 1413 (9th Cir. 1987)).

19. Again, as noted in Part I, *supra*, the 2004 case of *In re Clarent Corp.* was only the third case to go through trial to verdict since 1995, despite the fact that thousands of securities class actions have been filed since 1995.

Actual damages for a violation of Rule 10b-5 must be reduced by the “portion of the [stock’s] price decline that is the result of forces unrelated to the wrong. Such forces can be broadly categorized into: (1) company risk—the unique risk that is peculiar to the particular stock at issue, and (2) market risk—the risk associated with market wide variations generally.”²⁰ Judge Sneed, in *Green v. Occidental Petroleum Corp.*, assumed that where

the fraud-on-the-market is one involving either a false positive statement or a failure to disclose a negative fact, the price of the security will remain at a level above its unbiased value until a full corrective disclosure is issued. Accordingly, Judge Sneed put forth the concepts of a ‘price line’ and a ‘value line,’ in order to trace the degree of price inflation at various points in time.²¹

By determining the “price line” and the “value line,” an expert can then determine the stock price’s inflation due to fraud at any given period.

A. “PRICE LINE” AND “VALUE LINE”

“The price line is relatively easy to obtain, as it is merely a plot, over time, of the various prices at which trades in the security occurred.”²² On the other hand, the “value line,” or the value of the stock absent fraud, must be determined despite the fact that it is nearly impossible to correctly ascertain with any degree of certainty.²³ In the Ninth Circuit, this determination must be made by an expert who completes an “event study,” or similar analysis.²⁴ “An event study is a statistical regression analysis that examines the effect of an event on a dependant variable, such as a corporation’s stock price.”²⁵ In conducting an event study, the expert must remember that

[p]laintiffs are entitled to compensation only for the ‘residual’ price effect attributable to the fraud. . . . [T]he effects of at least three major factors that influence stock price must be identified and removed: (i) economy-

20. *In re Executive Telecard, Ltd. Sec. Litig.*, 979 F. Supp. 1021, 1025 (1997) (citing *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1342 (9th Cir. 1976)).

21. *Green*, 541 F.2d at 1341 (Sneed, J., concurring).

22. *In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1347-48 (9th Cir. 1994).

23. *Id.* at 1347-48; *In re Imperial Credit Indus. Inc. Sec. Litig.*, 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003) (“[A] proper measure of damages in the securities context . . . requires elimination of that portion which is unrelated to the alleged wrong.”) (internal citations omitted).

24. *In re Imperial Credit Indus. Inc. Sec. Litig.*, 252 F. Supp. 2d at 1014 (holding that an event study must account for both affirmative misstatements and material omissions as company-specific fraudulent activity that can cause stock value to decline).

25. *Id.*

wide information; (ii) industry information; and (iii) firm-specific information not related to the fraud.”²⁶

1. Economy-Wide and Industry-Specific Information

To determine the amount of a stock’s decline in value attributable to economy-wide or industry-pertinent factors, an expert must analyze the overall conditions in the securities market.²⁷ “Overall securities market conditions are often eliminated by using a broad-based standard market index such as the Standard & Poor’s 500 stock index or the Wilshire 5000 index.”²⁸

Furthermore, any decline in the price of a defendant company’s stock may be caused by industry-specific economic conditions.²⁹ Consequently, “it is necessary to eliminate these economic factors through the use of industry indices[, which] reflect the price behavior of similar types of securities issued by publicly traded companies.”³⁰ Since most companies do not fall within one single industry category, an expert usually needs to specially construct industry indices.³¹

2. Company-Specific, Non-Fraudulent Factors

The event study must also account for non-fraudulent, company specific factors.³² An expert completes an event study by

compiling the daily returns for a period not affected by the alleged fraud and then, using a regression model, calculating correlation coefficients or betas for each index. These coefficients are used with the index values for

26. Jon Koslow, Note, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 FORDHAM L. REV. 811, 819 (1991).

27. *In re Seagate Tech. II Sec. Lit.*, 843 F. Supp. at 1348.

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*; see discussion *infra* Section V for standards that an expert must adhere to when determining the company-specific, non-fraud related influences on the decline in a stock’s value. Additionally, it should be noted that an “event study” carries with it the problem of predicting “returns on trading days affected by fraud disclosures, even though significant non-fraud company information may also be revealed on these days. Performing a micro-analysis of trading patterns to try to correlate abrupt and abnormal price movements with a carefully prepared timeline of public information releases may provide a partial solution.” Koslow, *supra* note 26, at 825.

the period of the fraud to determine the unexplained random error term or portion of price behavior that cannot be explained by the market or industry indices. An analysis of these residual or unexplained price changes is undertaken to determine which of these might be explained by the influence of firm-specific, but non-fraud related, information, and which might be attributed to the fraud alleged. By separating out the fraud-related component of a security's price behavior in this fashion, it is possible to obtain the price profile the security likely would have exhibited had there been no fraud. This, by definition, is the "value line" Judge Sneed envisioned.³³

B. USING THE PRICE LINE AND VALUE LINE TO ASSESS DAMAGES

In summary, the "price line" reflects the amounts of money at which the stock traded, and the "value line" reflects the value of the security absent the fraud.³⁴ Once the "price line" and "value line" have been obtained and compared to each other, "[t]he difference between the two values represents the effect of the fraud, and thus the estimated damages, during the [class period]."³⁵

Clearly, however, the determination of the value line can never be an exact science. After all, the aforementioned market, industry, and

33. Koslow, *supra* note 26, at 825.

34. *Id.* at 819.

35. *Id.* *But see In re Executive Telecard, Ltd. Sec. Litig.*, 979 F. Supp. 1021, 1024-29 (S.D.N.Y. 1977). In that case from the Southern District of New York, the expert calculated damages by comparing a defendant company's "actual historical stock price during the Class Period, to . . . the stock's 'true value.'" *Id.* at 1024. The "true value" was determined by looking to the price at which the stock traded during a ten day period "following the publication of a *Barron's* article, which discussed the facts underlying [the company's] misstatements and omissions, including the class action complaint's allegation that [the company] had been overstating income." *Id.* The expert chose this period because "in the absence of other influences, the price of a fraudulently inflated security and its 'true' value should converge on or shortly after the date the fraud or misrepresentation was disclosed." *Id.*; see also *Basic, Inc. v. Levinson*, 485 U.S. 224, 246 (1988) (endorsing the "efficient market hypothesis"). The average difference between the historical price and true value was then "adjusted . . . to reflect a decline in the Standard & Poor's Long Distance Telephone Index." *Id.* Finally, the expert put the resulting number into a proprietary computerized model that reflected "adjustments for such factors as inflation, float, volume, intra day trading and short interest" to determine the damages. *Id.* The Court held the expert's damages valuation unreliable because he failed to conduct an event study that would reduce the damages due to company-specific non-fraud related factors, and he failed to compare the defendant company's stock to the stock of companies of similar volatility. *Id.* at 1024-27. Nevertheless, the Court indicates that such a damages valuation could be held reliable if it had accounted for the aforementioned factors. *Id.* at 1028-29.

company-specific factors elucidated by federal courts all have the potential to affect one another in an infinite number of ways. Such limitless potential scenarios make it nearly impossible to be certain that one has correctly estimated damages in a Rule 10b-5 case. Nevertheless, the federal courts have devised various formulas for ascertaining a plaintiff's damages, depending on the nature of the individual plaintiff's purchase or sale of stock.

1. Stocks Bought During Claim Period, One or No Stocks Sold During Claim Period

Green sets forth a method of calculating an individual plaintiff's damages where the plaintiff purchases stock in the class period and sells at least one share of stock within the class period, as represented by the following mathematical form:

$D = P * (PL_p - VL_p) - S * (PL_s - VL_s)$, where D represents damages to the individual; P represents the number of securities purchased in the class period; PL_p represents the price read from the price line at the time of purchase; VL_p represents the value taken from the value line at the time of purchase; S represents the number of securities sold in the period, with the added condition that the maximum value of S is equal to P; PL_s and VL_s represent, respectively, the amounts taken from the price line and value line at the point of sale. In this formula, the first product [$P * (PL_p - VL_p)$] represents the loss to the plaintiff caused by the fraudulent price inflation--i.e., the "extra" amount plaintiff was forced to pay in purchasing his securities. The second product [$S * (PL_s - VL_s)$], on the other hand, represents the amount by which plaintiff benefited from the fraud if and when he sold his shares.³⁶

2. Stocks Purchased During Claim Period, Yet Never Sold

However, a plaintiff may be a "retention plaintiff," which refers to a plaintiff who pays "an inflated price for the securities at the date of purchase[,] . . . never sells any securities[,] . . . [and] never benefits from the fraudulently inflated price in any manner."³⁷ Such a plaintiff's damages would be "the difference, at the time of purchase, between the price line and the value line, multiplied by the number of securities bought."³⁸ With

36. *In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1348-49 (9th Cir. 1994).

37. *Id.* at 1349.

38. *Id.*

reference to the above equation, the last term ($S * PLs - VLs$) would drop out, because S would equal zero; the plaintiff's damages could be determined with the equation: $D = P * (PLp - VLp)$.³⁹

3. Plaintiff both Bought and Sold Stock During Class Period

Yet another type of plaintiff both purchases and sells a company's securities at the inflated price—such investors are colloquially known as the “ins and outs.”⁴⁰ Unlike the aforementioned plaintiffs, this plaintiff is harmed by purchasing the stock at an inflated price, yet he also recoups some, if not all, of his investment upon resale at the inflated price.⁴¹ Thus, this plaintiff's damages must be deducted by the amount of money recouped upon resale.⁴²

Where the plaintiff resells all of his securities during the class period, with reference to the above formulas, $P = S$. The formula for determining this plaintiff's damages becomes: $D = P * (PLp - VLp) - (PLs - VLs)$.⁴³

4. Plaintiff Bought Stock During Class Period, Sold Some Stock During Class Period, and Retained Some Stock Until After the Fraud Was Revealed

A situation may arise where a Plaintiff purchased stock at an inflated price during the class period, sold some of that stock at an inflated price during the class period, yet retained some stock until after the company's fraud is revealed (and, thus, after the stock price drops).⁴⁴ In these cases, assuming the number of shares purchased is greater than the number of shares sold, “the existence and amount of damages will depend on the relative magnitudes of the purchases, sales, and amounts of fraudulent price inflation prevailing at the corresponding dates.”⁴⁵

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.* at 1350.

45. *Id.* It is possible that, in circumstances where the amount of money recouped by the plaintiff by selling an inflated stock at an inflated price within the class period may offset the money the plaintiff loses by failing to sell stock prior to the disclosure of the company's fraud and the subsequent drop in the shares' value. *Id.* at 1350, fn. 9. Cases have not addressed the propriety of such an offset. *Id.*

5. Aggregate Damages in Class Actions

To calculate aggregate class damages, the

[n]umber of securities purchased must be determined. This can be done in either of two ways: (1) collecting proofs of claims by persons trading in the security during the class period; or (2) estimating the volume of trading by using aggregate trading data. Method (1) can be costly and time consuming, while (2) requires use of assumptions that may not be correct. Because of the cost factor, estimation is usually employed. Estimating the number of shares which trade and thus are affected by the fraud-on-the-market is a complex endeavor, primarily because of intermediate trading (between broker-dealers) and the unavailability of trading records for all class members.⁴⁶

V. MANDATORY STANDARDS FOR ADMISSIBILITY OF AN EXPERT'S REPORT – CREATING THE VALUE DAMAGES

Before admitting expert testimony into evidence, the trial judge is charged with the gatekeeping obligation of ensuring that the testimony is both relevant and reliable.⁴⁷ This gatekeeping obligation applies to all expert testimony, including testimony based on technical and other specialized knowledge.⁴⁸ The trier of fact is not bound by the opinion of any expert witness and will accept or reject expert testimony, in whole or in part, in the exercise of sound judgment.⁴⁹

Although the standard governing the admissibility of expert testimony elucidated in *Daubert* was apparently limited to experts giving “scientific . . . knowledge” testimony, *Daubert's* general instruction still holds true: “[t]he focus [of the admissibility of Expert Witness’ testimony under Federal Rule of Evidence 702], of course, must be solely on principles and methodology, not on the conclusions that they create.”⁵⁰ Consequently, to ensure that the proper principles and methodology have been employed in an expert’s study, the federal courts demand that certain procedural steps occur. These steps include the use of an event study to determine the effect

46. *Id.* at 1349, fn. 8 (citing Koslow, *supra* note 26, at 841).

47. *Kumho Tire, LTD. v. Carmichael*, 526 U.S. 137, 147 (1999); *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 589 (1993).

48. *Kumho Tire, LTD.*, 526 U.S. at 141; *see* FED. R. EVID. 702.

49. *Lukens v. Comm’r of Internal Revenue*, 945 F.2d 92, 96 (5th Cir. 1991) (internal citations omitted).

50. *In re Executive Telecard, LTD. Sec. Litig.*, 979 F. Supp. 1021, 1024 (S.D.N.Y. 1997).

of market and non-fraud related company-specific events on the defendant company's stock, and a comparison in the decline of a defendant company's stock with the stock of companies that are comparably volatile.

A. VALUE LINE AND EVENT STUDY

Determining the "value line" in a damages valuation requires an in-depth evaluation of statistical evidence.⁵¹ Typically, an expert completes this evaluation; this is the situation in the case *sub judice*.⁵² However, an expert must arrive at his or her determination as to a given stock's "value line" by methods that satisfy Federal Rule of Evidence 702.⁵³

1. The Event Study Must Analyze Non-Fraud Related, Company Specific Activities That Affect the Stock's Value

Importantly, "[d]ecoding how much of the price behavior of a security is attributable to alleged market manipulation requires statistical analysis."⁵⁴ "Use of an event study or similar analysis is necessary . . . to isolate the influences of information specific to [a defendant company]."⁵⁵ Additionally, the event study must involve more than tracking price behavior of the price index that encompasses a defendant company's field.⁵⁶ For example, the *In re Executive Telecard* court rejected an expert's damages analysis used in *Winkler v. NRD Mining Ltd.*, in which an expert witness testified that all he did was "track[] the price behavior of an index of mining stocks during the class period, and used that information to remove the effect of general market forces from the price changes in NRD stock."⁵⁷ The *In re Executive Telecard* court held such an event study to be unsatisfactory, as the "proper methodology for eliminating that portion of

51. Koslow, *supra* note 26, at 819.

52. *Id.*

53. FED. R. EVID. 702 ("If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.").

54. *In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1348 (9th Cir. 1994).

55. *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993) (citing Koslow, *supra* note 26, at 822.); *see also In re Executive Telecard*, 979 F. Supp. at 1025 (holding that merely reading press releases side-by-side with a stock's daily price history does not suffice as an "event study," because it fails to consider the effect of company-specific events, such as a spinoff of a company's division to another country, on the company's stock).

56. *In re Executive Telecard*, 979 F. Supp. at 1026.

57. *Id.*

the price decline that is the result of forces unrelated to the wrong [] should include elimination of *both* general market factors and company specific-factors.”⁵⁸

2. When the Expert Witness Analyzes the Defendant Company’s Stock Against an Industry Price Index, the Defendant Company’s Stock Must Hold a Meaningful Correlation to That Price Index

When the expert compares a company’s stock to the stock of other companies in the same industry by using a price index, that price index must have a meaningful and precise correlation with the company’s stock price.⁵⁹ If the expert fails to value the stock against a precisely correlated index, the amount of a company’s stock’s decline in value attributable to market conditions potentially will be undervalued because the less-volatile companies in the index will likely suffer less of a decrease in stock value than may be felt by a highly volatile defendant company.⁶⁰ Consequently, if the plaintiffs improperly choose a price index, the plaintiffs risk failing to decrease the damages claim by the higher amount of stock depreciation attributable to external market conditions specific to a highly volatile industry.

B. ESTIMATING CLASS DAMAGES

As stated above, the damages determination in a 10b-5 class action often involves estimation because of the difficulty in determining the number of shares traded during the class period.⁶¹ In the settlement context, the court “does not require aggregate damages to be determined with mathematical precision.”⁶² However, the court must be satisfied that the expert used sound methodology in determining damages.⁶³ For example, an expert cannot use a “proportional decay” model that

58. *Id.* (emphasis added).

59. *Id.* at 1027, fn. 3 (holding that a “small-cap” stock company specializing in telecommunications that moves in accordance with the market’s expectations and perceptions of its long term economic prospects should not be valued against a portfolio of securities that includes highly capitalized companies that trade on reported earnings per share).

60. *Id.*

61. *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993).

62. *Id.* at 1182.

63. *Id.*

assume[s] that all investors are equally likely to trade, so that a 'proportional' number of shares are assumed to come from shareholders who are long-term holders and from those who are 'in-and-out' traders. [This is because] a share traded may have a much greater than proportional probability of being re-traded during the Class Period due to the disproportionate influence on trading of short-term traders, arbitrageurs, and similar market participants. *Failure to weight the likelihood of trading to reflect the characteristics of trading peculiar to [a defendant corporation] would likely result in a serious overestimation of aggregate damages.*⁶⁴

VI. A SHIFT FROM AWARDING DAMAGES TO STATUTORY FINES

One would not be shocked if the reader of this article, having made it thus far, has suffered a severe nose-bleed. Not only does the computation of damages in class action securities litigation involve improbably complex formulas that no lay juror would understand, there does not seem to be any way to independently verify whether one side's expert is simply "pulling the wool" over everybody's eyes. Thus, although an expert could probably prove to a jury that *some* damages occurred, it is not likely that the *exact* damages to be awarded to the plaintiff class can be established by a preponderance of the evidence. Given that the enactment of the PSLRA was meant to thwart "professional plaintiffs" and other abusive practices in private security class actions, a proposal that augments the damages requirement would be in keeping with this goal because it would make it harder for "professional plaintiffs" to blind the jury with arcane and complex formulas in order to convince them that an overestimated damages award is appropriate.⁶⁵

A. PROPOSAL FOR A COURT-APPOINTED EXPERT

To alleviate this problem, the legislature should mandate that the court appoint an expert, with the losing party ultimately paying the expert's fees.⁶⁶ This will prevent a "battle of the experts," which in this

64. *Id.* (emphasis added).

65. See, e.g., Donald Langevoort, *The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects*, 51 BUS. LAW 1157 (1996).

66. See Fed. R. Evid. 706 (allowing for court-appointed experts). Additionally, several states have provisions for the court-appointment of experts to investigate, report, or testify. See, e.g., Cal. Evid. Code § 730

(When it appears to the court, at any time before or during trial of an action, that expert evidence is or may be required by the court or by any part to the action, the

complicated arena has the potential to result in two diametrically opposite opinions from well-credentialed experts being presented to a jury of lay people. Having an objective, neutral expert from whom each side can adduce facts pertaining to damages will thus reduce the ability of “professional plaintiffs” to blind the jury with a flurry of numbers and complex theories. Litigators for both sides would be allowed to examine the expert on the stand in order to determine the basis for the expert’s opinion, as litigators currently can do with experts, but the existence of a neutral expert would nonetheless reduce bias and increase jurors’ faith in the accuracy of the neutral expert’s estimate.

Moreover, as trials can be bifurcated into liability and damages phases, the expert would not even take the stand unless and until there was a finding of liability by the fact-finder. Once, and if, liability has been established, the expert can take the stand for additional examination. Thus, if the fact-finder decides that a defendant is not liable for violating Rule 10b-5, the court’s time will not have to be taken up by the expert’s testimony and the fact-finder will not have been needlessly confused.

B. PROPOSAL FOR THE INSTITUTION OF FINES DISBURSED TO PLAINTIFF CLASS

Additionally, the legislature should eliminate the need to determine damages via the methods discussed in Part IV of this paper. Frankly, it is impossible to prove, with requisite certainty, how market forces, fraud, and non-fraud related company-specific factors interact to affect a stock’s price. Rather, it should simply be enough to establish the other elements of a Rule 10b-5 case, and leave it to the jury to determine (a) whether any damages occurred, and (b) the relative range of damages caused by the defendants’ bad acts. This will retain the need for an expert to establish damages in general terms that a jury is more capable of comprehending. Further, the fines can be distributed amongst the class based upon the number of shares held by each party. For example, the fine can be distributed, pro rata, to each class member based upon the amount of shares held by the class

court on its own motion or on motion of any party may appoint one or more experts to investigate, to render a report as may be ordered by the court, and to testify as an expert at the trial The court may fix compensation for these services”); Cal. Evid. Code § 731 (providing that, in civil actions, “the compensation fixed under Section 730 shall, in the first instance, be apportioned and charged to the several parties in such proportion as the court may determine and may thereafter be taxed and allowed in like manner as other costs.)

member following the disclosure of the fraud. Alternatively, the court-appointed expert could create a neutral value line and price line, as described above, which the class members can utilize to calculate their individual damages. When the damages for all of the class members are aggregated, the individual shareholder's damages will correspond to a given percentage of the aggregate damages, which will be the percentage of the fine that the class member receives.

The level of fines would be predicated (a) on the general amount of loss that the experts can prove was caused by the defendant's fraud, and (b) the average number of shares issued during the time period that the fraud was on-going. Further, the fines would be rather substantial, so as to deter companies from committing fraud. To set forth the levels of such fines would be an endeavor beyond my expertise. Suffice it to say, those with the requisite knowledge should be able to determine the levels of fines.

Some may complain that enacting such a proposal will cause shareholders to recover less than the amount of money that they lost due to the defendant's fraud. Indeed, absent use of a price-line/value-line model, those shareholders who both invest and sell their shares before evidence of a Rule 10b-5 violation arises may, quite simply, be unable to recoup losses potentially attributable to fraud; this does not seem completely unpalatable, since those investors will have already recouped a portion of their losses, and it seems insurmountably difficult to prove by a preponderance of the evidence that undisclosed fraud caused any loss at all in the value of one's shares. Given the nature of the securities market, however, investors must be mindful of the saying, *caveat emptor*. In other words, those shareholders who invest enough money in a public company to be significantly affected by a market fraud-created decline in stock price—those investors for whom a fraud-related decrease in stock value causes losses significant enough to justify the time and energy of a lawsuit—must bear the risk that the people running that company may commit fraud. They can research the company, diversify their securities portfolio, or take any other steps to avoid significant loss when a company, for example, misstates its yearly earnings. In any event, these people would at least receive a portion of the fine levied upon a liable defendant (and if the fines are high enough, then the recovery may significantly offset the investor's loss).⁶⁷

67. Moreover, bear in mind that the damages will typically be reduced in securities fraud class actions to account for attorneys' costs, expenses, and fees. Thus, even in the current system, the investor class will not necessarily recover *all* of their claimed losses.

VII. CONCLUSION

Despite the inherent difficulty in determining damages in a Rule 10b-5 claim, this article sets forth a primer on understanding exactly what an expert must do to establish damages. By proving both the “price line” and the “value line,” an expert can set forth his or her explanation of how market factors, fraud, and non-fraud related company-specific factors impact a stock’s price on a day-by-day basis. Practical understanding of this concept by a jury, however, is not going to be likely. Furthermore, the necessary uncertainty in aggregating class damages makes it impossible to establish an essential element of the Rule 10b-5 claim: damages. Thus, the federal legislature should enact a new statute that creates a fine to be paid by the violating defendant to the class, as opposed to an inexact amount of damages. While the plaintiff class’s expert would still need to prove the existence of damages by a preponderance of the evidence, the need to show exact damages would disappear. This would punish the defendant and compensate the plaintiff class, which ostensibly took the market risk that their stock’s value would plummet due to any number of reasons, including fraud.

* * *