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Ninth Circuit Adopts the Heightened Pleading Standard of Rule 9(b) for the Element of Loss Causation in Securities Fraud Actions

In *Oregon Public Employees Retirement Fund v. Apollo Group, Inc.*, No. 12-16624, 2014 WL 7139634 (9th Cir. Dec. 16, 2014), the Ninth Circuit held that Rule 9(b) of the Federal Rules of Civil Procedure, which requires that “[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake,” applies to *all* elements of a claim under Section 10(b), including loss causation. The Ninth Circuit is now the third federal court of appeals to hold that Rule 9(b) requires that the element of loss causation be pleaded with particularity. By contrast, the Fifth Circuit has held that the less rigorous standard set forth in Rule 8(a) of the Federal Rules of Civil Procedure governs the pleading of the element of loss causation. This divergence in the case law among the courts of appeals renders the issue of the applicable pleading standard for the element of loss causation an increasingly attractive candidate for United States Supreme Court review.

Prior to its decision in *Oregon Public*, the Ninth Circuit had applied a “plausibility” test as the pleading standard for loss causation. The Ninth Circuit’s “plausibility” test provided that so long as “the complaint allege[d] facts that, if taken as true, plausibly establish[ed] loss causation, a Rule 12(b)(6) dismissal [was] inappropriate.” *In re Gilead Sciences Sec. Litig.*, 536 F.3d 1049, 1057 (9th Cir. 2008). While this “plausibility” test closely tracked the pleading requirement under Rule 8(a) as interpreted by the Supreme Court in *Bell Atlantic v. Twombly*, 550 U.S. 544 (2008), the Ninth Circuit had not, prior to *Oregon Public*, outright endorsed either Rule 8(a) or Rule 9(b) as the appropriate standard for pleading loss causation. *See Oregon Pub.*, 2014 WL 71139634, at *3.

With the *Oregon Public* decision, the Ninth Circuit has now joined the Fourth and Seventh Circuits in applying the heightened standard of Rule 9(b) to the element of loss causation. *See id.*, 2014 WL 7139634, at *3 (citing *Katyle v. Penn Nat’l Gaming, Inc.*, 637 F.3d 462, 471 (4th Cir. 2011,) and *Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824, 842 (7th Cir. 2007)). By contrast, the Fifth Circuit applies the “traditional pleading standard under [Rule] 8(a)” (*see id.* (citing *Lormand v. U.S. Unwired, Inc.*, 565 F.3d 228, 258 (5th Cir. 2009))), which requires “a short and plain statement” of the elements of a claim (Fed. R. Civ. P. 8(a)). The First Circuit has declined to address whether Rule 8(a) or Rule 9(b) governs the pleading of loss causation. *See, e.g., Mass. Ret. Sys. v. CVS Caremark Corp.*, 716 F.3d 229, 239 n.6 (1st Cir. 2013). The *Oregon Public* court also interpreted the Second Circuit’s case law to have avoided taking a direct position on whether Rule 8(a) or Rule 9(b) governs this issue. *Oregon*

Pub., 2014 WL 71139634, at *3 (citing *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 107 (2d Cir. 2007)).

Background and Decision

In *Oregon Public*, the shareholders in Apollo Group, Inc., which owns and operates for-profit postsecondary education institutions, brought a putative shareholder class action against Apollo Group and its officers and directors. Plaintiffs alleged that defendants made false and misleading statements of material fact relevant to Apollo's financial condition, including statements concerning its enrollment, revenue growth, organizational values and management integrity. Among other claims, plaintiffs alleged that Apollo Group grew largely as a result of unethical recruitment of unqualified students, and that this information was misrepresented in or omitted from its public filings.

According to plaintiffs, the truth was subsequently revealed when, among other events, the company disclosed that the Department of Education had expressed concern that some students had enrolled and begun attending classes before they had completely understood the implications of enrollment, including their eligibility for student financial aid. Plaintiffs also alleged that the truth was further revealed when the Government Accountability Office issued a report discussing systemic practices of manipulative and deceptive recruitment practices in the for-profit education industry more generally.

On a motion to dismiss in the district court, Judge James I. Teilborg, United States District Judge for the District of Arizona, dismissed plaintiffs' claims in their entirety. *In re Apollo Grp., Inc. Sec. Litig.*, No. CV-10-1735-PHX-JAT, 2012 WL 2376378, at *1 (D. Ariz. June 22, 2012). In particular, Judge Teilborg dismissed certain of the claims asserted under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 for a failure to plead loss causation. Judge Teilborg—without indicating whether he was applying the standard set forth in Rule 8(a) or Rule 9(b), or the plausibility standard described by the Ninth Circuit—held that plaintiffs failed to allege how the supposed “corrective disclosure relate[d] to a securities fraud analysis—because [the complaint] does not show that a corrective disclosure revealed that a past statement made by specific Defendants was knowingly false.” *Id.* at *8. Judge Teilborg reasoned that “[t]his is an important distinction in securities fraud cases because if a company could be sued for securities fraud every time it corrected problems discovered within the company, without showing that Defendants were previously aware of those problems and purposefully misrepresented the nature of the problems to investors, then every time a company tried to improve its business, it would potentially be liable for securities fraud.” *Id.*

On appeal, plaintiffs argued that Judge Teilborg applied an “incorrect and overly strict pleading standard by, *inter alia*, finding corrective disclosures insufficient to establish loss causation where they did not reveal the knowing falsity of Defendants' statements.” *Oregon Pub. Emps. Ret. Fund v. Apollo Grp., Inc.*, Brief for the Plaintiffs-Appellants, No. 12-16624, 2012 WL 5387258, at *11 (9th Cir. Oct. 28, 2012). In response, defendants argued that plaintiffs had failed to establish loss causation under *any* standard,

whether it be that set forth under Rule 8(a) or Rule 9(b) or the Ninth Circuit's plausibility standard. Defendants further maintained that the appropriate pleading standard for loss causation is set forth in Rule 9(b). *Oregon Pub. Emps. Ret. Fund v. Apollo Grp., Inc.*, Brief for the Defendants-Appellees, No. 12-16624, 2012 WL 5387258, at *35 (9th Cir. Dec. 19, 2012).

The Ninth Circuit affirmed the district court in all respects. Most notably, however, the Ninth Circuit agreed with defendants that Rule 9(b)'s specificity requirement should apply to the pleading of loss causation in a Section 10(b) case. The court gave three reasons for its decision to adopt the heightened standard:

- First, citing Supreme Court precedent, the *Oregon Public* court noted that both “the law on securities fraud” and “[t]he requirement of loss causation, in particular,” are “founded on the common law of fraud and deceit.” *Id.* at *4. “Since Rule 9(b) applies to all circumstances of common-law fraud,” the court reasoned, “and since securities fraud is derived from common law fraud, it makes sense to apply the same pleading standard to all circumstances of securities fraud.” *Id.*
- Second, the court found that the text of Rule 9(b) supports its application here. The court noted that loss causation, as one of the six elements of a cause of action under Section 10(b), is part of the “circumstances constituting fraud or mistake” referenced in Rule 9(b) because “without it, a claim of securities fraud does not exist.” *Id.*
- Third, the court observed that applying Rule 9(b) in this context will create consistency in the standard by which courts “assess pleadings in 10(b) actions” and will dispense with the “piecemeal standard adopted by some courts.” *Id.*

Turning to the allegations made in *Oregon Public*, the court held that plaintiffs' complaint did not adequately allege loss causation because plaintiffs failed to allege “specific statements made by the Defendants that were made untrue or called into question by subsequent public disclosures.” *Id.* at *7. In so holding, the court found that plaintiffs' allegations were so deficient that the claim would not have survived a motion dismiss under *either* Rule 8(a) or 9(b). *Id.*

For example, the court explained that it was “unclear what claims made by the Defendants were invalidated by” the subsequent disclosure that the Department of Education had expressed concerns about student enrollment procedures. *Id.* The court held that “[a]n expression of concern [] does not constitute a corrective disclosure.” *Id.* The court further noted that Ninth Circuit precedent holding that “a company's announcement of an internal investigation, by itself, does not ‘reveal fraudulent practices to the market’ and therefore is insufficient to establish loss causation,” similarly supported dismissal of plaintiffs' claims. *Id.* Likewise, the court found that the industry-wide review conducted by the Government Accountability Office was too general to establish a causal relationship between the company's stock price activity and its own statements.

Analysis

Under the heightened pleading standard of Rule 9(b), plaintiffs in the Ninth Circuit will be unable to survive a motion to dismiss under Section 10(b) if plaintiffs do not plead loss causation with particularity. Under *Oregon Public*, plaintiffs must plead specific facts demonstrating a direct causal relationship between the knowing misstatement by defendants and the purported corrective disclosure. Generic disclosures and disclosures that are not clearly linked to the specific alleged misstatements will not suffice.

Moreover, this decision further exacerbates the previously existing circuit split created by the divergent approach of the Fifth Circuit, as compared to that of the Fourth and Seventh Circuits, discussed above. Ultimately, this circuit split may be resolved by the Supreme Court, which expressly noted but declined to resolve in *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336, 346 (2005), the open question of whether Rule 8(a) or Rule 9(b) applies to the pleading of loss causation.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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