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In *Omnicom* Second Circuit Provides Guidance On What Type Of Information Will Justify Investor Reliance For Securities Fraud

In *In re Omnicom Group, Inc. Securities Litigation*, No. 08-0612-CV, 2010 WL 774311 (2d Cir. Mar. 9, 2010), the United States Court of Appeals for the Second Circuit affirmed the district court's grant of summary judgment dismissing a securities fraud class action for failure to proffer sufficient evidence to support a finding of loss causation. The Second Circuit held that plaintiffs failed to show that the decline in the issuer's stock price occurred as a result of a disclosure of new information about the alleged fraud. At most, the investor losses arose from the negative press and investor concerns about possible accounting problems. As the Second Circuit stated, however, an issuer is not responsible under the securities laws for losses arising merely from "investors' concerns that other unknown problems [are] lurking.

Omnicom, through its subsidiary, Communicade, invested in internet marketing and advertising companies. These companies were Communicade's sole assets. Though the value of these investments began to drop in 2000, Omnicom did not report these losses, determining that they were not "other than temporary impairments." Instead, in early 2001, Omnicom and Pegasus Partners II LP, a private equity firm, created a new company, Seneca. Omnicom transferred Communicade and $47.5 million in cash to Seneca, and Pegasus promised to transfer $12.5 million in cash to Seneca up front, and another $12.5 million upon Seneca's request. Omnicom received $325 million in Seneca's non-voting preferred stock, and Pegasus received all of Seneca's common stock.

Omnicom reported it would incur no gain or loss from the Seneca transaction because it was exchanging the internet companies plus $47.5 million in cash for Seneca's preferred stock of equivalent value. The companies' valuation at $277.5 million was based in part on Pegasus's willingness to invest $25 million in Seneca. However, Pegasus only transferred $100 to Seneca and transferred the $12.5 million to a Pegasus holding company instead. Additionally, Omnicom allegedly misrepresented the value of its Seneca stock by arranging for Seneca, rather than Omnicom, to buy a technology license from one of Seneca's investee companies. Seneca would then sell the license to Omnicom for $75 million, which would nearly offset Seneca's yearly losses.

Between Spring 2001 and June 2002, numerous news articles and industry reports covering the Seneca transaction suggested that it was an elaborate accounting scheme to move the struggling internet companies off Omnicom's books. While many articles expressed concern over Omnicom's accounting, none suggested that Omnicom had engaged in any illegal activity. On June 5, 2002, Omnicom disclosed that an outside director and chair of Omnicom's Audit Committee resigned from the board of directors. While Omnicom did not disclose the reasons the director resigned, media coverage suggested that his resignation was due, in part, to his concerns over the accounting of the Seneca transaction.

Media coverage of the Seneca transaction culminated in a prominent article in the *Wall Street Journal* on June 12, 2002. The *Journal* article directly linked the directors' departure to the Seneca transaction. The article also referred to statements by two accounting professors who stated the transaction "raised a red flag," and who questioned whether the exchange had been made for fair value. The article also voiced general concerns over Omnicom's day-to-day accounting practices. The same day, Omnicom held a telephone conference with its investors, in which it stated that the director's reasons for resigning "were presented accurately as in '*The Journal*' this morning."

Omnicom's stock dropped over twenty-five percent relative to trading prices and activity in the market and the industry in the two days following the June 12, 2002 *Journal* article. However, after Omnicom announced that its new auditor, KPMG, reviewed the accounting for the Seneca transaction and had not recommended any changes, Omnicom's stock increased substantially relative to the industry and the market.

Plaintiffs asserted claims against Omnicom for violations of Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. Plaintiffs alleged that (1) Omnicom should have written down the value of the internet companies before engaging in the Seneca transaction; (2) the accounting of the Seneca transaction was fraudulent because Omnicom failed to appropriately value the internet companies; and (3) Omnicom should have accounted for Seneca's losses after the Seneca transaction occurred because Omnicom controlled Seneca.

An essential element of a securities fraud claim is loss causation, *i.e.*, that the alleged fraud caused plaintiffs to suffer a monetary loss. *See Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342 (2005). To support a showing of loss causation, plaintiffs proffered an event study analysis prepared by an expert who was prepared to testify that "the investing public's initial reactions to the partially corrective disclosures in June 2002 were tied to the news of Omnicom's inappropriate accounting for investments in Internet-related entities and not to other news during that time period." The expert claimed further that "[i]nvestors legitimately feared that Omnicom's transfers of its Internet investments created the potential for losses and hidden liabilities and/or had allowed Omnicom to hide losses in the past," and stated that Omnicom's stock price would not have declined over the June 5 to June 13, 2002 period "had Defendants not previously engaged in the fraudulent scheme alleged by Plaintiffs." The district court granted summary judgment to defendants, holding that this evidence was not sufficient to show loss causation.

On appeal, the Second Circuit focused on the fact that the alleged fraud was the subject of continuing media reports beginning in May 2001, but the stock decline did not take place until a year later, in June 2002. Following *Teacher's Retirement System of La. v. Hunter*, 477 F.3d 162, 187-88 (4th Cir. 2007), and *In re Merck & Co. Securities Litigation*, 432 F.3d 261, 269-70 (3d Cir. 2005), the Court held that the information disclosed to the market in June 2002, namely that the director's resignation was directly linked to the Seneca transaction, was simply a negative characterization of previously known information and did not constitute corrective disclosure of any new information, because the use of the Seneca transaction as an accounting method to remove losses from Omnicom's books was known to the market at least a year before the director resigned. The Court held that the plaintiffs' expert's event study did not draw a causal connection between the information in the June 12 article and the fraud alleged in the complaint, but "merely linked the decline in the value of [Omnicom's] stock to various events."

Further, the Court held that plaintiffs had not shown any losses were materialization of the risks associated with the allegedly fraudulent Seneca transaction. Applying the Second Circuit's "zone of risk" test outlined in the dissenting opinion in *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202 (2d Cir. 2000), the Court held that because Omnicom's internet losses were publicly known the only concealed fraud could have been the invalidity of Omnicom's accounting for those losses through the Seneca transaction. Because the facts were known a year before the director's resignation, and because the resignation did not add any new material fact about the Seneca transaction to the public knowledge, plaintiffs could not claim that investors had ever been told that improper accounting had in fact occurred with regard to the Seneca transaction. The Court concluded that the generalized investor reaction of concern causing a temporary share price decline in 2002 was far too tenuously connected to the Seneca transaction to support securities fraud liability.

As the Supreme Court explained in *Dura Pharmaceuticals*, the requirement for pleading and proving loss causation exists because private securities fraud actions are "available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." 544 U.S. at 345. *Omnicom* confirms that in the absence of temporal proximity between the actual corrective disclosure and the stock price decline, courts are skeptical of plaintiffs' ability to prove that they are seeking compensation for fraud and not attempting to collect on investor insurance.

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