

Recession Makes Pleading Loss Causation More Difficult

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Plaintiffs in securities fraud cases are required to plead "loss causation" to state a cause of action. In times of economic turmoil, such as a recession, this pleading requirement may be harder for plaintiffs to satisfy. In fact, courts are recognizing with increasing frequency that "distilling the impact of defendants' account irregularities from an overlapping national recession and specific downturns in particular markets can increase [plaintiffs'] risk of proving loss causation."¹

Background

In a private cause of action for securities fraud, plaintiff must plead and prove that defendant made a material misrepresentation or omission with scienter in connection with the purchase or sale of a security.² Plaintiff must also plead and prove that it relied upon the misrepresentation or omission, that it suffered an economic loss, and that the misrepresentation or omission was the cause of its loss.³ One aspect of this "cause" element is "loss causation," the "causal link" between defendant's alleged fraudulent conduct, on the one hand, and the economic loss plaintiff ultimately suffered, on the other.⁴ Thus, to plead causation adequately, a plaintiff must allege that "the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security."⁵

The seminal case on loss causation is the U.S. Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*.⁶ In *Dura*, the Supreme Court held that a plaintiff does not sufficiently plead loss causation by merely alleging that the price of the security on the date of purchase was inflated because of defendant's misrepresentation. As the Court explained:

When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, *but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events*, which taken separately or together account for some or all of that lower price. . . . Other things being equal, the longer the time between purchase and sale, the more likely that this is so, *i.e.*, the more likely that other factors caused the loss.⁷

As such, the Court required that a plaintiff establish that it was the revelation of the fraud that caused plaintiff's loss, rather than one of the "tangle of factors" that affected a company's stock price.⁸

Although the *Dura* Court never expressly addressed how an economic recession affects loss causation, defendants are now arguing that a recession is one of the factors affecting stock prices. Typically, a defendant argues that plaintiff failed to plead that its losses were caused by defendant's alleged misrepresentations or omissions, as opposed to the recession. This argument is meeting with success, and as a result, securities actions are being dismissed in increasing numbers for failure to plead loss causation.⁹

Post-Dura Cases Addressing Economic Turmoil

The U.S. Court of Appeals for the Second Circuit is one of the most prolific Circuits, if not the most prolific Circuit, in addressing causation and economic turmoil since *Dura* was decided by the Supreme Court. In 2006, in *Leykin v. AT&T Corp.*, the U.S. District Court for the Southern District of New York found that plaintiff did not effectively plead loss causation where it failed to "allege facts showing that it was the claimed concealment which caused plaintiffs' losses, rather than the . . . market-wide Internet stock collapse . . . nor [did plaintiff] propose any way to separate the effect of the misstatements (if there was any) from the general collapse or other causes."¹⁰ Consequently, the Court dismissed plaintiff's complaint.

In 2008, in *In re Merrill Lynch & Co. Research Reports Securities Litigation*, the Court dismissed plaintiff's complaint with prejudice, noting that "the present Complaint does not address the ten-month decline of [defendant's] stock price and does not attempt to explain how the decline of the stock price . . . was attributable to the alleged fraud, rather than simply a continuation of the loss in value that afflicted [defendant] during the Internet sector's collapse."¹¹ In dismissing the complaint, the Court relied heavily on the fact that defendant's stock price had declined for an extended period of time. This is similar to the analysis that the Court employed in *60223 Trust v. Goldman, Sachs & Co.*¹² Specifically, the *60223 Trust* Court noted that defendant's stock had been gradually losing value for an extended period of time, yet "[t]he complaint d[id] not even refer to the phenomenon of the gradual loss of the stock's value, much less attempt to explain it as related to loss causation."¹³ As such, the *60223 Trust* Court concluded that plaintiff had not sufficiently pled loss causation and dismissed the complaint.

In *Shanahan v. Vallat*, defendants argued that plaintiff's loss was caused by adverse market conditions in China, and the Court agreed.¹⁴ The Court found that when "the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospects that the plaintiff's loss was caused by the fraud decreases." Plaintiff's claim fails when it cannot be proven that the loss was caused by the alleged misstatements or omissions as opposed to the intervening cause.¹⁵ Indeed, the Court held that "no reasonable jury could determine that, with respect to the Chinese one-way paging market, Plaintiffs' losses were due to anything other than 'industry-wide phenomena that destroyed all or most' companies whose business activities resembled those of [Defendant]."¹⁶ As such, the Court found that plaintiffs were unable to make a claim for loss causation sufficient to sustain their claims.

In *In re Moody's Corp. Securities Litigation*, defendants argued that "the decline in [their] stock price was due to the direct intervening cause of market collapse, specifically the market crash as a result of the subprime mortgage crisis."¹⁷ The Court noted that, while issues of causation are typically reserved for trial and are not appropriate for Rule 12(b)(6) motions to dismiss, "[w]here there is a market-wide downturn in a particular industry . . . [p]laintiffs must show that their loss was caused by the [d]efendants' fraud, rather than the intervening events, in order to survive a motion to dismiss."¹⁸ Although the Court ultimately declined to grant defendants' motion to dismiss, it did so only after determining that it lacked a sufficient basis for concluding that there had been a market-wide downturn in the credit-ratings industry at the time of defendant's disclosures.¹⁹

While the vast majority of cases addressing the issue of causation and market turmoil are from the Second Circuit, recently there have been indications that other Circuits may soon follow the Second Circuit's approach. In *Luminent Mortgage Capital, Inc. v. Merrill Lynch & Co.*, defendants argued that plaintiffs' losses were not the result of any fraud but, rather, stemmed from "the unexpected collapse of the real estate and mortgage markets, which ha[ve] caused all mortgage-backed securities to suffer dramatic losses."²⁰ Relying on two Second Circuit decisions, the Court acknowledged that "when the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors,'—i.e., the stock market bust—the prospect that the plaintiff's loss was caused by the fraud decreases, and a plaintiff's claim fails when it has not adequately pled facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events."²¹ The Court then concluded that "the one-and-a-half year time period between the alleged misrepresentation and the injury combined with the market downturn in the mortgage industry that developed in early to mid-2007, is sufficient to undermine the inference of a nexus between Defendants' misrepresentations and the performance of the

[securities]."²² Because plaintiffs "allege[d] no facts to support their assertion that Defendants' misrepresentations in 2005—rather than the market dislocation that occurred in 2007—caused an economic loss," the Court dismissed the complaint for failure to plead loss causation.²³

There is some indication that the U.S. Court of Appeals for the Seventh Circuit may adopt the Second Circuit's approach.²⁴ In explaining the difference between loss causation and transaction causation, the *Maxwell v. KPMG, LLP* Court provided the following hypothetical:

Suppose an issuer of common stock misrepresents the qualifications or background of its principals, and if it had been truthful the plaintiff would not have bought any of the stock. The price of the stock then plummets, not because the truth is discovered *but because of a collapse of the market for the issuer's product wholly beyond the issuer's control*. There is 'transaction causation,' because the plaintiff would not have bought the stock, and so would not have sustained the loss, had the defendant been truthful, but *there is no 'loss causation,'* because the kind of loss that occurred was not the kind that the disclosure requirement that the defendant violated was intended to prevent. To hold the defendant liable for the loss would produce overdeterrence by making him an insurer against conditions outside his control. Also, it is bad policy to encourage people harmed in some natural or financial disaster to cast about for someone on whom to lay off the consequences who had, however, committed only a technical breach of duty. The legal system is busy enough without shouldering the burden of providing insurance against business risks. Had the investor diversified his investments, he would not have taken such a big hit when the Houston real estate market collapsed.²⁵

Conclusion

As the current recession continues, plaintiffs will likely find it more and more difficult to satisfy the standards of pleading and proving loss causation. Simply pointing to a decrease in stock price is no longer sufficient: plaintiffs must demonstrate much more. The impact of economic turmoil is a substantial impediment to successfully bringing private securities fraud actions.

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- ¹ *In re Cardinal Health Inc. Sec. Litigs.*, 528 F. Supp. 2d 752, 766 (S.D. Ohio 2007) (internal quotations omitted).
- ² See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341–342 (2005).
- ³ *Id.*
- ⁴ *Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 161, 172 (2d Cir. 2005).
- ⁵ *Id.* at 173.
- ⁶ See 544 U.S. 336 (2005).
- ⁷ *Id.* at 342–343 (emphasis added).
- ⁸ *Id.* at 343.
- ⁹ Defendants were successfully relying on general economic conditions even before *Dura*. For example, in *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763 (2d Cir. 1993), the Second Circuit affirmed the dismissal of a complaint, finding that plaintiffs had failed to plead loss causation sufficiently. Specifically, the Court noted:
- When a significant period of time has elapsed between the defendant's actions and the plaintiff's injury, there is a greater likelihood that the loss is attributable to events occurring in the interim. *Similarly, when the plaintiff's loss coincides with a market wide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases.*
- Id.* at 772 (emphasis added).
- ¹⁰ *Leykin v. AT&T Corp.*, 423 F. Supp. 2d 229, 246 (S.D.N.Y. 2006).
- ¹¹ *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 568 F. Supp. 2d 349, 364 (S.D.N.Y. 2008).
- ¹² *60223 Trust v. Goldman, Sachs & Co.*, 540 F. Supp. 2d 449 (S.D.N.Y. 2007).
- ¹³ *Id.* at 461.
- ¹⁴ *Shanahan v. Vallat*, No. 03-CV-3496, 2008 BL 220765 (S.D.N.Y. Oct. 3, 2008).
- ¹⁵ *Id.* at *10 (quoting *First Nationwide Bank*, 27 F.3d at 772) (internal citation omitted).
- ¹⁶ *Id.* (quoting *Bastian v. Petren Resources Group*, 892 F.2d 680, 685 (7th Cir. 1990)).
- ¹⁷ *In re Moody's Corp. Sec. Litig.*, 599 F. Supp. 2d 493, 513 (S.D.N.Y. 2009).
- ¹⁸ *Id.*
- ¹⁹ *In re Moody's Corp. Sec. Litig.*, 612 F. Supp. 2d 397, 400 (S.D.N.Y. 2009).
- ²⁰ *Luminent Mortg. Capital, Inc. v. Merrill Lynch & Co.*, 652 F. Supp. 2d 576, 592 (E.D. Pa. Aug. 20, 2009) (internal quotations omitted).
- ²¹ *Id.* at 593 (quoting *Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 161, 174 (2d Cir. 2005) (citing *First Nationwide Bank*, 27 F.3d at 772)).
- ²² *Luminent Mortg. Capital, Inc.*, 652 F. Supp. 2d at 593.
- ²³ *Id.*
- ²⁴ See *Maxwell v. KPMG, LLP*, 520 F.3d 713 (7th Cir. 2008).
- ²⁵ *Id.* at 717 (internal quotations omitted).

