



# SECURITIES REGULATION & LAW



## REPORT

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### ANTIFRAUD

## Loss Causation and the Global Economic Crisis

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**W**hen fraud coincides with a stock market crash, one question inevitably looms large. What caused the investors' losses: the fraud or outside economic forces? In the present economic environment, widely regarded as the worst financial crisis since the stock market crash of 1929, the courts will have to grapple with this central question of causation.

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Causation was front and center in a recent decision in *Countrywide Financial Corporation Securities Litigation*. There, in what appears to be the first ruling to address causation in investments tied to the subprime mortgage industry,<sup>1</sup> the United States District Court for the Central District of California held that plaintiffs had adequately pled causation despite the market crash. This article discusses the court's analysis of causation in the *Countrywide* case, and addresses generally the

<sup>1</sup> In a related derivative case, *In re Countrywide Financial Corp. Derivative Lit.*, 554 F. Supp. 2d 1044, 1065-66 (C.D. Cal. 2008) the court considered the market collapse in deciding whether the plaintiffs adequately alleged scienter, an essential element of a securities fraud claim under section 10(b) of the Securities Exchange Act of 1934. There, the court stated, "Independent of any turmoil in the capital markets, the widespread violations of underwriting standards, as alleged, would significantly raise the risk of loan default." *Id.* However, the court made this determination outside the context of its consideration of any argument as to loss causation. Similarly, in *Tripp v. IndyMac Financial Inc.*, No. CV07-1635, 2007 WL 4591930 at \*8 (C.D. Cal., Nov. 29, 2007), the court held that the plaintiffs' allegations were inadequate to raise a cogent and compelling inference of scienter because, "an even stronger inference is that Defendants were simply unable to shield themselves as effectively as they anticipated from the drastic change in the housing and mortgage markets . . ." Again, while this conclusion would be relevant to a loss causation analysis, the court in *IndyMac* arrived at its conclusion in consideration of a different element of the alleged securities fraud claim.

impact of the current financial crisis on the requirement that plaintiffs plead loss causation in securities fraud cases.

## I. The Countrywide Complaint

The plaintiffs in the *Countrywide Securities Litigation* alleged a fraud covering nearly four years, from March 12, 2004 through March 7, 2008. During that period, Countrywide substantially increased its share of the market for residential mortgage lending. It retained a portion of the loans it issued and securitized and sold the balance. A significant portion of the loans it issued were subprime mortgages, which refer to loans, secured by mortgages, issued to borrowers who have poor credit histories. Countrywide also issued certain exotic loan products during that period, including “negative amortization loans” and interest only loans.

The complaint alleged that beginning in 2003, to increase its market share, Countrywide progressively lowered loan underwriting standards, “to the point of nearly abandoning them by 2006,”<sup>2</sup> and made substantial exceptions even to those lowered standards.<sup>3</sup> By relaxing its lending requirements, Countrywide allowed borrowers with lower credit ratings to take out larger loans with higher loan-to-value ratios.<sup>4</sup> These increasing loan-to-value ratios represented increased risk, because, with a higher ratio, borrowers had less incentive to repay the loans, and there was a reduced likelihood that Countrywide would recover the full value of the loan through foreclosure in the event the borrower defaulted.<sup>5</sup> Further, Countrywide issued mortgage loans to borrowers without verifying income, assets or employment, and engaged in other practices that substantially increased the risks of its business model.<sup>6</sup>

At the same time, Countrywide not only failed to disclose any of those risks to its investors, it made contrary public representations as to the purportedly conservative and prudent nature of its lending practices.<sup>7</sup> The plaintiffs alleged that through these and other false statements and omissions, the defendants inflated the value of Countrywide’s stock, and, when investors finally learned the truth, Countrywide’s stock collapsed. Defendants countered that it was the wider economic crisis, rather than fraud, that caused the investors losses. Specifically, Defendants claimed that as a result of the decline in the U.S. economy, overall housing prices dropped substantially, causing “liquidity challenges” for Countrywide and other participants in the mortgage industry. Defendants sought dismissal on the ground that the broader economic collapse, and specifically the “burst” in the “housing bubble,” was an intervening cause that defeated claims for securities fraud.

## II. Loss Causation and the Securities Laws

The court’s discussion of causation in *Countrywide* related to plaintiffs’ claims under Section 10(b) of the

Securities Exchange Act of 1934 and Sections 11 and 12 of the Securities Act of 1933. A private plaintiff asserting claims of securities fraud under the Securities Exchange Act of 1934 has the burden of proving that the acts or omissions constituting the fraud actually “caused the loss for which the plaintiff seeks to recover damages.”<sup>8</sup> The courts refer to this as loss causation and require plaintiffs to plead it in the complaint.<sup>9</sup> The doctrine of loss causation derives from the rule in fraud cases at common law that “losses do ‘not afford any basis for recovery’ if ‘brought about by business conditions or other factors . . . .’”<sup>10</sup>

The statutory basis of the loss causation requirement is not found within the Securities Exchange Act of 1934 itself. Rather, proving loss causation is a heightened requirement, passed by Congress in the Private Securities Litigation Reform Act of 1995, which is imposed on private litigants alleging securities fraud.<sup>11</sup> The PLSRA’s loss causation requirement does not apply to securities fraud actions brought directly by the SEC<sup>12</sup>, and thus loss causation is not pleaded in the SEC’s recently filed action against Angelo Mozilo, the former chairman and CEO of Countrywide, David Sambol, the former president and chief operating officer, and Erik Sieracki, the former chief financial officer.<sup>13</sup>

In claims under Sections 11 and 12 of the Securities Act, the plaintiffs do not have to plead loss causation. However, defendants can avoid liability if they prove that something other than the alleged false statements or omissions caused the plaintiffs losses.<sup>14</sup> The courts refer to this defense as “negative causation.”<sup>15</sup> Although loss causation is not an element of the claims under the Securities Act, courts have granted motions to dismiss such claims when “the face of the complaint

<sup>8</sup> 15 U.S.C. § 78u-4(b)(4).

<sup>9</sup> *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345-46 (2005).

<sup>10</sup> *Id.* at 344-45.

<sup>11</sup> 15 U.S.C. § 78u-4(b)(4); *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. \_\_\_; 128 S.Ct. 761 (2008) (“[T]he PLSRA . . . imposed heightened pleading requirements and a loss causation requirement upon ‘any private action’ arising from the Securities Exchange Act.”).

<sup>12</sup> *Dura*, 544 U.S. at 339 (citing loss causation as a statutory requirement that Congress has imposed “on th[e] private action” implied from § 10(b)) (emphasis added); *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. \_\_\_; 128 S.Ct. 761 (2008) (“[T]he PLSRA . . . imposed heightened pleading requirements and a loss causation requirement upon ‘any private action’ arising from the Securities Exchange Act.”) (emphasis added).

<sup>13</sup> Complaint for Violation of the Federal Securities Laws, *SEC v. Angelo Mozilo, et al.*, CV09-03994 (C.D. Cal. June 4, 2009) (“Complaint”). The facts alleged in the complaint are largely consistent with those alleged in *Countrywide Financial Securities Litigation*, *supra*. In addition to charging the defendants with violations of Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), and Rule 10(b), 17 C.F.R. § 240.10b-5, the SEC also alleges the defendants committed fraud in the offer or sale of securities pursuant to Section 17(a) of the Securities Exchange Act, 15 U.S.C. § 77q(a), violated reporting requirements pursuant to Section 13(a), 15 U.S.C. § 78t(e), and certified 10-K forms for the years 2005-07 that contained untrue statements, in violation of Rule 13a-14, 17 C.F.R. § 240.13a-14. See Complaint at ¶¶ 125-37.

<sup>14</sup> 15 U.S.C. § 77k(e) (Section 11) and 15 U.S.C. § 77l(b) (Section 12).

<sup>15</sup> *In re Countrywide Fin. Corp. Sec. Litig.*, 2008 WL 5100124 at \*26.

<sup>2</sup> *In re Countrywide Fin. Corp. Sec. Litig.*, \_\_\_ F. Supp. 2d \_\_\_, No CV-07-05295, 2008 WL 5100124 at \*3 (C.D. Cal. Dec. 1, 2008).

<sup>3</sup> *Id.* at 4-5.

<sup>4</sup> *Id.* at 4.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 6.

<sup>7</sup> *Id.* at 10-11.

or judicially noticeable facts demonstrate that the plaintiff cannot establish loss causation.”<sup>16</sup>

### III. Causation and Intervening Cause

The Supreme Court addressed the pleading requirements for loss causation in a securities fraud case in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005). There, the Court held that an allegation of inflation in the purchase price alone was not sufficient to plead loss causation. It dismissed the complaint for failing to plead that the price of the defendants’ stock fell after the disclosure of the truth.<sup>17</sup>

In *Dura*, the Court addressed the possibility that even a decline in share price following a disclosure of the truth might not establish loss causation when there is an intervening market decline or other event, stating:

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.<sup>18</sup>

However, the issue of intervening cause was not before the Court in *Dura*. The case was on appeal from the Ninth Circuit Court of Appeals to address the narrow question of whether a plaintiff could prove loss causation by pleading merely that the fraud inflated the value of the investment on the date of purchase.<sup>19</sup> The Court was careful to limit its holding to the facts then before it, stating:

[W]e find the Ninth Circuit’s approach inconsistent with the law’s requirement that a plaintiff prove that the defendant’s misrepresentation (or other fraudulent conduct) proximately caused the plaintiff’s economic loss. We need not, and do not, consider other proximate cause or loss-related questions.<sup>20</sup>

Thus, although *Dura* discussed the possibility that a change in market conditions might account for an investors’ losses, that discussion was *dicta*. *Dura* did not hold that it was impossible to plead loss causation when a fraud coincides with a crash in the financial markets.

*Dura* cited with approval the decision of the Seventh Circuit Court of Appeals in *Bastian v. Petren Resources Corp.*,<sup>21</sup> one of the seminal decisions on intervening cause in securities fraud cases. In *Bastian*, the Seventh Circuit affirmed the dismissal of a complaint for failure to plead loss causation when an intervening crash in oil and gas prices caused the plaintiffs’ losses. The court expressly based its ruling on the plaintiffs’ failure to allege why their investments lost value.<sup>22</sup> The court reasoned that if plaintiffs had not invested in the defendants’ venture, they would have found another investment in the oil and gas industry and sustained the same losses. As the court explained:

Like a stock-market crash, the collapse of oil prices in the early 1980s reverberated throughout the economy. . . . If the

defendants’ oil and gas ventures failed not because of the personal shortcomings that the defendants concealed but because of industry-wide phenomena that destroyed all or most such ventures, then the plaintiffs, given their demonstrated desire to invest in such ventures lost nothing by reason of the defendants’ fraud and have no claim to damages.<sup>23</sup>

In *Bastian*, the court dismissed the complaint because the plaintiffs there did not allege why their investment lost value. Other courts have reached the same result when plaintiffs failed to offer plausible explanations for the decline in the value of their investments in the face of a market crash or other intervening events.<sup>24</sup> A Tenth Circuit Court of Appeals’ opinion in *In re Williams Securities Litigation*, for instance, found that the plaintiff’s expert had failed to demonstrate the allegedly loss-causing effect of the fraud at issue, or to isolate it from market forces at play. The court found the plaintiff had failed to provide evidence that the truth related to the fraud had been communicated to the market before the stock declined, and noted that “the same period witnessed the bankruptcies of [defendant’s] competitors,” a general decline in the defendant’s industry sector, as well as “the overall market declines that followed the 9/11 terrorist attacks.”<sup>25</sup>

However, the courts have not always denied allegations of loss causation in the face of a market crash or other intervening cause. For example, in *Semerenko v. Cendant Corp.*, another case that the Supreme Court cited with approval in *Dura*, the complaint alleged that the defendants filed false financial statements in connection with a proposed merger with ABI, a public com-

<sup>23</sup> *Id.* at 685.

<sup>24</sup> *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 534 F.3d 1068, amended, 540 F.3d 1049 (9th Cir. 2008) (plaintiff failed to plead loss causation when it offered an implausible explanation for the price decline and when there was an intervening cause that coincided with the price decline in the form of an announcement that the company had missed its earnings guidance); *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 772 (2d Cir. 1994) (In a case where plaintiff’s losses on its investment in real estate coincided with a crash in the real estate market, the court affirmed the dismissal of claims in a RICO action because plaintiff “has not adequately plead facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events.”); *In re Retek Inc. Securities Litigation*, Memorandum Opinion and Order, Civil No. 02-4209 (D. Minn. March 31, 2009) (granting defendant’s motion for summary judgment for claims of securities fraud based on multiple alleged violations of GAAP principles, which the Court found had not been causally related to a drop in stock price following a write off of deferred income).

<sup>25</sup> 2009 WL 388048 (10th Cir. Feb. 18, 2009).

### Note to Readers

The editors of BNA’s *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

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<sup>16</sup> *Id.*

<sup>17</sup> *Dura*, 544 at 346-47.

<sup>18</sup> *Id.* at 342-43.

<sup>19</sup> *Id.* at 341.

<sup>20</sup> *Id.* at 346.

<sup>21</sup> 892 F.2d 680 (7th Cir. 1989).

<sup>22</sup> *Id.* at 684.

pany, causing the stock of ABI to be artificially inflated, and causing the price of ABI's stock to drop when Cendant announced a restatement.<sup>26</sup> The defendants claimed that the announcement of the merger was an intervening cause of the appreciation in ABI's stock, and the announcement of the termination of the merger agreement, which coincided with the restatement, was an intervening cause of the loss.<sup>27</sup> The court rejected these arguments, stating that the plaintiff had adequately pled loss causation by alleging "that it purchased shares of ABI common stock at a price that was inflated due to the alleged misrepresentations, and that it suffered a loss when the truth was made known and the price of ABI common stock returned to its true value."<sup>28</sup> *Semerenko* held that the allegations of intervening causes would not bar recovery, "so long as the alleged misrepresentations were a substantial cause of the inflation in the price of a security and in its subsequent decline in value."<sup>29</sup> While it allowed the defendants to disprove at trial that the alleged fraud was the substantial cause of the inflation and subsequent decline in value, the court held that the existence of an intervening cause was a question of fact that it could not resolve at the pleading stage.<sup>30</sup> Other courts, including the Second Circuit Court of Appeals, have agreed with *Semerenko*, that the question of whether an intervening event caused the loss "is a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss."<sup>31</sup>

A recent Fifth Circuit case may be particularly instructive in litigation in which the present-day financial crisis becomes an issue in the loss causation analysis. *Alaska Electrical Pension Fund v. Flowserve Corp.* is a per curiam opinion in which retired Supreme Court Justice Sandra Day O'Connor sat on the panel. It affirms the principle the plaintiff's loss must result from the revelation of the alleged securities fraud—and not, for instance, changed market conditions independent of the fraud.<sup>32</sup> More interestingly, it discusses *Lormand v. US Unwired*, 2009 WL 941505 (5th Cir. Apr. 9, 2009), in which US Unwired misled the public about the expectations it had for success after Sprint forced the company to enter the subprime cellular service market. There, through a "series of disclosures through which some

truth leaked out," it became "increasingly clear that there were substantial problems in the subprime market."<sup>33</sup> Despite the gradual revelations in that case and the generalized market conditions, *Alaska Electrical* approves of *Lormand's* finding that "the plaintiffs could demonstrate that their losses were caused by those misstatements when the relevant truth leaked out."<sup>34</sup>

#### IV. Countrywide and Intervening Cause

In *Countrywide*, the defendants claimed that an "unprecedented" external 'liquidity crisis' caused all (or most) of Countrywide's decline."<sup>35</sup> The court recognized that "dramatic market shifts will raise complicated questions on damages" but stated that "[i]t will be the fact-finder's job to determine which losses were proximately caused by Countrywide's misrepresentations and which are due to extrinsic or insufficiently linked forces."<sup>36</sup> The court concluded that the complaint's allegations "invite the cogent and compelling inference that Countrywide's deteriorating lending standards were causally linked to at least some of the macroeconomic shifts of the past year."<sup>37</sup> That is, the plaintiffs had sufficiently alleged that Countrywide's previously undisclosed practices and the current economic crisis were not independent phenomena—that one had much to do with the other. In so holding, the court pointed to the complaint's quotation of former Treasury Secretary Paulson, who said, "[T]his turbulence wasn't precipitated by problems in the real economy. This came about as a result of some bad lending practices."<sup>38</sup> Accordingly, the court held that the plaintiffs had adequately pleaded loss causation, notwithstanding that Countrywide attributed the difficulties that caused its stock market price to fall to the market-wide liquidity crunch.

#### V. Conclusion

The Court's decision in *Countrywide* with regard to the loss causation issue is similar to that by the court in *DeMarco v. Robertson Stephens Inc.*, 318 F. Supp.2d 110, 123 (S.D.N.Y. 2004). There, Judge Gerard Lynch rejected the argument that the bursting of the telecommunications stock bubble was necessarily an intervening cause requiring dismissal at the pleading stage. He concluded that the complaint adequately alleged that defendants had participated in inflating the bubble with their misrepresentations, much as Judge Mariana Pfaelzer held in *Countrywide* that the complaint adequately alleged that the liquidity crisis was linked to defendants' poor underwriting practices. If plaintiffs in other cases are able to make similar allegations with regard to the alleged wrongful conduct of the defendant banks or companies in those cases, and the courts in those suits agree with Judges Pfaelzer and Lynch, it will be difficult for defendants charged with securities fraud in the subprime market to show that the market crash was

<sup>26</sup> 223 F.3d 165, 170-71 (3d Cir. 2000).

<sup>27</sup> *Id.* at 183-84.

<sup>28</sup> *Id.* at 185.

<sup>29</sup> *Id.* at 187.

<sup>30</sup> *Id.*

<sup>31</sup> *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003); see also *In re Daou Systems, Inc.*, 411 F.3d 1006, 1025 (9th Cir. 2005) ("A plaintiff is not required to show 'that a misrepresentation was the sole reason for the investment's decline in value' in order to establish loss causation . . . '[A]s long as the misrepresentation is one substantial cause of the investment's decline in value, other contributing forces will not bar recovery under the loss causation requirement' but will play a role 'in determining damages.'" (quoting *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 n.5 (11th Cir. 1997); *AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 215 (2d Cir. 2000) ("we specifically noted there that we did not intend to bar a plaintiff from successfully pleading 'proximate cause when the claim follows a market collapse'") (citing *First Nationwide*, 27 F.3d at 772).

<sup>32</sup> *Alaska Electrical Pension Fund v. Flowserve Corp.*, No. 07-11303 c/w No. 08-10071 (5th Cir. June 19, 2009) (per curiam).

<sup>33</sup> *Id.* (citing *Lormand v. US Unwired*, 2009 WL 941505, at \*27).

<sup>34</sup> *Id.* (citing *Lormand v. US Unwired*, 2009 WL 941505, at \*29).

<sup>35</sup> 2008 WL 5100124 at \*28.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

an intervening cause requiring dismissal at the pleading stage.