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The Importance of a Causation "Defense" In Post-Credit Crisis Investment Litigation

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Nearly a decade ago, the United States Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345 (2005), emphasized that a securities fraud suit is not an investor's insurance policy against market losses. As courts continue to address the fallout from the financial crisis that began in 2007, the Court's admonition is alive and well, and frequently appearing in decisions addressing claims under § 10(b) of the Securities Exchange Act of 1934 and common law claims involving structured products such as mortgage-backed securities. Just recently, two federal courts observed in the § 10(b) context that "[t]he securities laws are not an insurance policy for investments gone wrong, inexperience, bad luck, poor choices, or unexpected market events,"[i] nor are they "a prophylaxis against the normal risks attendant to speculation and investment in the financial markets."[ii]

A key battleground where this maxim often comes into play involves an investor's attempt to demonstrate that investment losses were caused by the defendant's alleged misconduct. While there is nothing novel about the concept that a plaintiff may only recover losses *actually caused* by a defendant's misconduct,[iii] courts increasingly are citing a plaintiff's inability to plead or prove causation as the basis to reject claims involving alleged misconduct that occurred during or shortly after the credit crisis. This trend has important implications for defendants and their counsel. The stakes are quite high because, as the Second Circuit put it succinctly (in upholding a § 10(b) claim at the pleading stage), "ultimately, the [plaintiff may] recover nothing because defendants will prove that any diminution in value is attributable to, *e.g.*, . . . (2) the global financial crisis[.]"[iv]

Nonetheless, causation is not a magic bullet, and defendants should be mindful of, among others, the following issues:

- Prevailing on causation on a motion to dismiss remains difficult because courts do not uniformly require plaintiffs to disaggregate their alleged losses at the pleading stage.
- A defendant also may not be able to obtain summary judgment based on causation because plaintiffs are not always required to establish that *all* of their claimed losses were attributable to

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the defendant's alleged misconduct. Some courts require only that the plaintiff show that the defendant was responsible for a *portion* of those losses.

- Where the investments at issue are privately-offered structured securities, rather than publicly-traded stocks, a causation defense obviously is neither governed by *Dura* nor proven by reference to a concurrent drop in market price. In these cases, whether for claims of common law fraud, negligence, or breach of contract, traditional notions of causation typically apply and may represent a lower bar for a plaintiff to clear. This is important to keep in mind because of the prevalence of credit crisis cases based on common law claims as opposed to under § 10(b).
- If a motion to dismiss is denied, consideration should be given to obtaining discovery regarding, and ultimately putting on trial, the plaintiff's own investment activity. While courts are not always receptive to defendants' discovery requests into plaintiffs' investments, such evidence can be highly effective in undermining a plaintiff's attempts to prove causation (or, for that matter, any misconduct) where the plaintiff made investments comparable to those it claims in litigation were improper.

I. CAUSATION DEFINED

The causation element of a claim under § 10(b) or at common law requires that a plaintiff plead and prove a "'[proximate] causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.'"[v] Causation is typically shown in § 10(b) and common law fraud cases involving publicly-traded stock, at least in part, by pointing to a drop in the stock price following a corrective disclosure.[vi] Likewise, at common law, a plaintiff must show that his or her investment losses were proximately caused by the alleged misconduct.[vii] "[A] misstatement or omission is the 'proximate cause' of an investment loss if the risk that caused the loss was within the zone of risk *concealed* by the misrepresentations and omissions alleged by a disappointed investor."[viii] A defendant can defeat the plaintiff's attempts to show causation "if the loss was caused by an intervening event" or something other than the conduct at issue.[ix] Thus, it is the plaintiff's burden to "disaggregate those losses caused by 'changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events.'"[x]

II. RECENT DECISIONS

A. Section 10(b) Cases

1. *Central States, Se. & Sw. Areas Pension Fund v. Federal Home Loan Mortg. Corp.*, No. 12-4353-cv, 2013 U.S. App. LEXIS 22413 (2d Cir. Nov. 5, 2013)

In 2011, investors who purchased Federal Home Loan Mortgage Corp. ("Freddie Mac") securities issued in 2007-2008 brought a § 10(b) claim against Freddie Mac, alleging that the company misrepresented its exposure to subprime loans and the sufficiency of its internal controls. In affirming the district court's dismissal of the complaint at the pleading stage, including for failure to plead loss causation, the Second Circuit observed that "[w]here, as here, the plaintiff's stock purchases and losses coincided with a marketwide phenomenon—the housing bubble burst—'the prospect that the plaintiff's loss was caused by the fraud decreases,' and therefore the plaintiff must plead facts sufficient to show 'that its loss was caused by the alleged misstatements as opposed to intervening events.'"[xi] The plaintiffs had not done so, the Second Circuit held, because their own allegations revealed that Freddie Mac's stock price had been falling gradually even prior to the release of the alleged corrective disclosures. The plaintiffs' allegations of loss causation were fatally flawed because, *inter alia*, they failed to connect Freddie Mac's "subprime exposure, or any alleged misrepresentations regarding it, to the events that [were] alleged to have caused the relevant stock price decline."[xii]

2. *Lighthouse Fin. Grp. v. Royal Bank of Scot. Grp., PLC*, No. 11 Civ. 398, 2013 U.S. Dist. LEXIS 111979 (S.D.N.Y. Aug. 5, 2013)

Shareholders of Royal Bank of Scotland ("RBS") brought a § 10(b) claim against RBS (a bank that the court described as having been "severely affected by the financial crisis of 2007-2009"), alleging that, from August 2007-February 2008, the bank made material misrepresentations about its exposure to subprime residential mortgage-backed securities ("RMBS").[xiii] After the court granted RBS's motion to dismiss the plaintiffs' amended complaint on the grounds that RBS's alleged misstatements were neither false nor made with *scienter*, it then also rejected the plaintiffs' request for leave to amend a second time. The court found, among other things, that the proposed second amended complaint "fail[ed] for the independent reason that it [did] not adequately plead loss causation."[xiv] The court cited a 2011 report by the U.K. Financial Services Authority ("FSA") as "cast[ing] doubt on the notion that RBS's share price declined on account of any actionable securities fraud."[xv] The court noted that the FSA report "list[ed] six major factors that led to RBS's decline, most of which concerned the fragility of the entire banking system and RBS's large exposure to low quality assets."[xvi] According to the court, "[n]one of th[ose] factors implied that accounting irregularities or public misstatements or omissions played any role in the market losing confidence in RBS and its ultimate demise."[xvii]

3. *Delshah Grp. LLC v. Javeri*, No. 09-Civ-6909, 2013 U.S. Dist. LEXIS 74817 (S.D.N.Y. May 28, 2013)

An investor who had purchased membership interests in a Manhattan commercial real estate project asserted a § 10(b) claim based on allegations that the sellers misrepresented that the project was "running smoothly" and failed to disclose that the previously-projected timeline for completion was inaccurate.[xviii] After a bench trial, the court found that the plaintiff's claims "fail[ed] at every level."[xix] The court rejected the plaintiff's expert's opinion on loss causation and found that, even assuming the defendants made material misstatements and/or omissions, "the following factors caused the project to fail: unanticipated delays occurring after plaintiff had purchased its interest, the serious financial crisis in full bloom by the fall of 2008, and the serious deterioration in the New York City real estate market."[xx] The court concluded that the financial crisis and severe real estate market decline was the cause of the plaintiff's loss, not any fraud by the defendants:

> The risk of an unprecedented crash in the financial and housing markets was present irrespective of any misrepresentations regarding the Project schedule or cost overruns. It was not concealed. Defendants could only be held responsible for the damage that was reasonably related to the alleged misrepresentations and omissions; *an epic financial crisis was not one of those risks*. That all investors in the 40 Broad Project lost large sums of money is evident. But it was not because of securities fraud.[xxi]

4. Other Decisions

Consistent with *Central States*, *Lighthouse*, and *Delshah*, several other recent decisions have highlighted that the defense of loss causation can be a powerful weapon in defendants' arsenal at all stages of a litigation:

- *In re Moody's Corp. Sec. Litig.*, No. 07 Civ. 8375, 2013 U.S. Dist. LEXIS 122449, at *38 (S.D.N.Y. Aug. 23, 2013) (dismissing investors' § 10(b) claim against Moody's on summary judgment because "neither [the expert's] report nor any other evidence proffered by Plaintiffs establish that market forces and other factors unrelated to Moody's alleged mismanagement of its conflicts of interest did not play a significant role in Plaintiffs' economic loss").
- *In re Citigroup Inc. Bond Litig.*, No. 08 Civ. 9522, 2013 U.S. Dist. LEXIS 117838, at *28 (S.D.N.Y. Aug. 20, 2013) (noting, in approving securities class action settlement, that "in order to be awarded damages, plaintiffs would have had to contend with Citigroup's defense that the historic events occurring in the financial world between May 2006 and November 2008—in particular the market collapse in the latter months of 2008—caused their losses, rather than the misstatements or omissions allegedly made").

- *In re Thornburg Mortg., Inc. Sec. Litig.*, 912 F. Supp. 2d 1178, 1255 (D.N.M. 2012) (noting in attorney fee approval context that "[l]oss causation would have been difficult to prove in this case, given that Plaintiffs' claims coincide with a period when real-estate backed securities lost value across the nation").
- *Hubbard v. BankAtlantic Bancorp, Inc.*, 688 F.3d 713, 729-30 (11th Cir. 2012) (affirming grant of judgment as a matter of law in favor of defendant *after jury returned verdict partially in favor of plaintiffs* because plaintiffs provided no "indication, however rough, of how much of the decline in [defendant's] stock price resulted not from the fraud but from the fraud but from the general downturn in the Florida real estate market").

B. Common Law Structured Products Cases

Defendants also have had increased success in defeating claims outside the Section 10(b) context by pointing to the effects of the financial crisis. In particular, courts have rejected common law tort claims relating to investment losses in structured securities based on the plaintiff's failure to plead or prove that the defendant's misconduct, as opposed to market forces, caused the losses in question.

For example, in *Financial Guaranty Insurance Co. v. Putnam Advisory Co.*, No. 12 Civ. 7372, 2013 U.S. Dist. LEXIS 129120 (S.D.N.Y. Sept. 10, 2013), Financial Guaranty Insurance Co. ("FGIC") agreed to insure a $900 million tranche of a collateralized debt obligation ("CDO") issued in 2006 by The Putnam Advisory Group ("Putnam"), which defaulted in 2008. FGIC then sued Putnam for common law fraud, alleging that the CDO's offering documents falsely represented that the CDO's collateral would be selected solely by Putnam when, in fact, the collateral was selected by a hedge fund that held a short position with respect to the CDO (thus, according to FGIC, "incentiviz[ing] [the hedge fund] to select weak collateral that would eventually cause [the CDO] to fail").[xxii] Dismissing FGIC's claim for failure to adequately plead loss causation, the court explained that, while FGIC alleged that it was the hedge fund's selection of default-prone collateral that caused the FGIC-insured tranche to default, "FGIC ha[d] not buttressed [that allegation] with facts sufficient to demonstrate that there was *any* pool of collateral that could have avoided default while still conforming to [the CDO's] detailed eligibility criteria," especially in light of the global market downturn.[xxiii]

Similarly, in *Loreley Financing (Jersey) No. 4 Ltd. v. UBS Ltd.*, 963 N.Y.S.2d 566 (Sup. Ct. N.Y. Cty. 2013), a New York state trial court dismissed a common law fraud claim against the issuer of a CDO, the collateral of which consisted of RMBS and credit default swaps ("CDS") that defaulted. Echoing *Dura*'s admonition against filing lawsuits in an attempt to secure insurance against market losses, the court stated that the "[plaintiffs'] $331 million investment in the subject CDOs represented a massive bet on the health of the housing market" that ultimately "cost them dearly," and, "like so many investors, [plaintiffs] seek to hold the arrangers of CDOs and CDS

counterparties liable for their losses."[xxiv] The court rejected the plaintiffs' claim because, "unlike other cases in which the plaintiff alleged a nexus between the defendant and the failure of RMBS, here, there are no allegations that the securities at issue were compromised by *defendants*."[xxv]

Other cases in which courts have rejected post-recession common law claims asserted in connection with structured securities on loss causation grounds include:

- *Bank of Am., N.A. v. Bear Stearns Asset Mgmt.*, No. 08 Civ. 9265, 2013 U.S. Dist. LEXIS 125700, at **13, 16, 28 (S.D.N.Y. Sept. 3, 2013) (dismissing at summary judgment investors' claims for breach of fiduciary duty and breach of contract against CDO issuer because "Plaintiffs are unable to prove how much, if any, of their damages can be traced to the ultimate disclosure of the information that Plaintiffs allege was wrongfully withheld," as opposed to the "effects of fire sales stemming from a liquidation of the Funds" at issue during the financial crisis).
- *Fulton Bank, N.A. v. UBS Sec., LLC*, No. 10-1093, 2011 U.S. Dist. LEXIS 128820, at **44, 57 (E.D. Pa. Nov. 7, 2011) (dismissing at pleading stage common law fraud claim premised on UBS's alleged intentional concealment of risks associated with auction-rate securities market because failures of plaintiff's investments "were fundamentally caused by intervening macroeconomic phenomena, namely, a decrease in [auction-rate securities] demand ultimately stemming from a global credit crisis").

In addition, the financial crisis' effects on the element of loss causation are also being seen in cases outside of the securities and structured products contexts. *See, e.g., Ariel Preferred Retail Grp., LLC v. CWCapital Asset Mgmt.*, 883 F. Supp. 2d 797, 826 (E.D. Mo. 2012) (contract not voidable on ground of economic duress where plaintiffs "admitted that their financial stress was due to a downturn in the economy in 2008-09" rather than any conduct of defendant); *Catler v. Arent Fox, LLP*, 71 A.3d 155, 184 (Md. Ct. Spec. App. 2013) (affirming summary judgment in favor of defendant dismissing legal malpractice claim regarding advice on real estate financing project because the "nation's largest recession since the Great Depression" was a "significant, intervening event" with respect to plaintiffs' losses on the project).

III. PRACTICAL CONSIDERATIONS

As courts continue to dispatch post-recession investment loss claims, plaintiffs are likely to face a difficult battle in establishing that the defendant's misconduct, as opposed to market conditions, caused their losses. However, outcomes vary, and we offer the following considerations for defendants and their counsel.

The Causation Defense At The Pleading Stage. It is difficult for defendants to prevail on a motion to dismiss based on this defense. Courts often have found that allegations providing at

least "'"*some* indication of the loss and the causal connection that the plaintiff has in mind"'" are sufficient to withstand a motion to dismiss and create a question of fact. *Tutor Perini Corp. v. Banc of Am. Sec. LLC*, No. 11-10895-NMG, 2013 U.S. Dist. LEXIS 136455, at *64 (D. Mass. Sept. 24, 2013) (emphasis added; citations omitted); *see also Federal Hous. Fin. Agency v. JPMorgan Chase & Co.*, 902 F. Supp. 2d 476, 498-99 (S.D.N.Y. 2012) (whether "'losses . . . sustained were attributable to fraud, rather than the systemic and market-wide decline in the housing market'" was question of fact not to be resolved on motion to dismiss); *Prudential Ins. Co. of Am. v. Credit Suisse Sec. (USA) LLC*, No. 12-7242, 2013 U.S. Dist. LEXIS 142191, at *54 (D.N.J. Sept. 30, 2013) (allegation that "there [was] a value gap between where the certificates are now and where they would be if the underlying loan pools were as described" sufficiently pled loss causation because "[t]he quantum of that gap need not be alleged with specificity in the complaint as it 'is usually reserved for the trier of fact'") (citation omitted); *Phillips v. Triad Guar. Inc.*, No. 1:09CV00071, 2013 U.S. Dist. LEXIS 77734, at *47 (M.D.N.C. May 31, 2013) (rejecting argument on motion to dismiss that "drop in stock price was most likely caused by changing economic conditions and the general decline in stock prices" because court would not draw "alternative inferences for the drop" at the pleading stage).

Nonetheless, while plaintiffs "are not expected to conduct an event study [at the pleading stage]," defendants should raise causation defenses on a motion to dismiss where plaintiffs have selected unduly wide event windows for their allegations, which might bring into play market-wide phenomena even at the pleading stage. *In re Security Cap. Assur., Ltd. Sec. Litig.*, 729 F. Supp. 2d 569, 600 & n.5 (S.D.N.Y. 2010) (noting that event study methodology is instructive to evaluating pleadings on loss causation and dismissing § 10(b) claim because "Plaintiffs' allegations themselves incorporate intervening events and actors, and at times present (rather inexplicably) wide event windows that welcome into their narrative noise and information from other events that make it difficult to isolate the impact of Defendants alleged misrepresentations").

Total vs. Partial Loss Causation. Defendants should be aware that plaintiffs may be able to survive summary judgment even if they cannot establish that all of their losses were caused by the defendant's alleged misconduct. *See Abu Dhabi Com. Bank v. Morgan Stanley & Co.*, 888 F. Supp. 2d 431, 472 (S.D.N.Y. 2012) (rejecting defendant's argument on summary judgment "that plaintiff's losses were caused by the unprecedented and market-wide liquidity crisis that began in 2007" because "[s]ummary judgment is inappropriate so long as plaintiffs provide evidence 'that would allow a factfinder to ascribe some *rough* proportion of the whole loss to the defendant's alleged misstatements'") (emphasis in original; citation omitted); *King Cty., Wash. v. IKB Deutsche Industriebank AG*, 916 F. Supp. 2d 442, 452-53 (S.D.N.Y. 2013) (same). In other words, loss causation is not an "all or nothing" concept. Defendants therefore should be sure to engage competent experts who can account for all of the plaintiff's alleged losses.

Publicly-Issued vs. Privately-Offered Securities. "[P]roving loss causation in connection with the sale of privately-offered asset-backed securities such as [rated notes] is a different undertaking from proving loss causation in a typical stock drop case." *AIG Global Sec. Lending Corp. v. Banc of Am. Sec. LLC*, 646 F. Supp. 2d 385, 403 (S.D.N.Y. 2009), *aff'd*, 386 F. App'x 5 (2d Cir. 2010) (Summary Order). In the case of publicly-traded securities, loss causation typically is demonstrated by proof of "an immediate and measureable drop in the price of the [stock]" following a corrective disclosure. *Abu Dhabi Com. Bank*, 888 F. Supp. 2d at 473. In the case of privately offered structured products such as commercial mortgage-backed securities, RMBS and CDS, however, such a highly liquid market typically does not exist and, instead, "loss causation [may be demonstrated] by showing a causal link between the fraud and a 'decrease in the amount of money returned to [the plaintiff] over the course of the securitization.'" *Id.* (citation omitted); *see also Thrivent Fin. for Lutherans v. Countrywide Fin. Corp.*, No. 2:11-cv-07154-MRP-MAN, 2012 U.S. Dist. LEXIS 71376, at *14 (C.D. Cal. Feb. 17, 2012) (loss causation sufficiently pled by allegation that defendant misrepresented risk profile of RMBS and, as a result, plaintiffs' RMBS investments "are now worth less than they paid for them"). With securities fraud cases related to the credit crisis on the decline and breach of contract cases on the rise, defendants should keep this distinction in mind in evaluating their ability to defeat a plaintiff's attempts to prove causation.

Putting Plaintiff's Own Investments On Trial. Inquiring into the plaintiff's own investments may be part of an effective defense strategy and a way to defeat a plaintiff's attempt to establish causation, particularly in defending against claims that the defendant was negligent in selecting investments for a CDO or other portfolio. In such a case, establishing that the plaintiff made comparable investments in the same entities, industries, or geographic regions may be an effective way to rebut allegations of negligence or other misconduct. Courts may or may not be receptive to such a discovery request, but it is a potentially effective way to undermine plaintiffs' claims, including the element of causation. *Compare Crigger v. Fahnestock & Co.*, 443 F.3d 230, 236 (2d Cir. 2006) (defendant was permitted to introduce evidence of plaintiffs substantial and varied investment experience) *with Abu Dhabi Com. Bank v. Morgan Stanley & Co.*, No. 08 civ. 7508, 2013 U.S. Dist. LEXIS 38787, at *42 (S.D.N.Y. Mar. 20, 2013) ("Although defendants will be entitled to submit evidence that a market-wide collapse caused plaintiffs' losses, an inquiry into plaintiffs' other investments is a more prejudicial than probative method of refuting loss causation").

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[i] *Delshah Grp. LLC v. Javeri*, No. 09-Civ-6909, 2013 U.S. Dist. LEXIS 74817, at *1 (S.D.N.Y. May 28, 2013).

[ii] *Meyer v. Greene*, 710 F.3d 1189, 1196 (11th Cir. 2013).

[iii] *See, e.g., King Cty., Wash. v. IKB Deutsche Industriebank AG*, 708 F. Supp. 2d 334, 342 (S.D.N.Y. 2010) ("[defendants] claim that it was this credit crisis . . . that caused plaintiffs' losses").

[iv] *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145, 167 n.15 (2d. Cir. 2012), *cert. denied*, 133 S. Ct. 1624 (2013).

[v] Lattanzio v. Deloitte & Touche, LLP, 476 F.3d 147, 157 (2d Cir. 2007) (discussing loss causation under § 10(b)) (citation omitted); see also Bastian v. Petren Res. Corp., 892 F.2d 680, 683 (7th Cir. 1990) ("what securities lawyers call 'loss causation' is the standard common law fraud rule") (emphasis in original); *McCabe v. Ernst & Young*, No. Civ. 01-5747, 2006 U.S. Dist. LEXIS 524, at *41 (D.N.J. Jan. 6, 2006) ("To recover their investment losses under common law fraud or negligent misrepresentation, Plaintiffs must prove that Defendant's alleged misrepresentations proximately caused their loss"), *aff'd*, 494 F.3d 418 (3d Cir. 2007).

[vi] *See Massachusetts Ret. Sys. v. CVS Caremark Corp.*, 716 F.3d 229, 237-38 (1st Cir. 2013) (loss causation under § 10(b) is "commonly establish[ed]" by, *inter alia*, "showing that the stock price dropped soon after the corrective disclosure"); *Emergent Cap. Inv. Mgmt., LLC v. Stonepath Grp., Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) ("the proximate cause element of common law fraud requires that plaintiff adequately allege a causal connection between defendants' non-disclosures and the subsequent decline in the value of [the] securities").

[vii] *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005).

[viii] *Id.* (emphasis in original); *see also Maxwell v. KPMG, LLP*, No. 03 C 3524, 2007 U.S. Dist. LEXIS 52647, at *14 (N.D. Ill. July 19, 2007) ("In order to prove proximate causation, the Trustee must offer evidence demonstrating that KPMG's alleged negligence caused Whittman-Hart's losses"), *aff'd*, 520 F.3d 113 (7th Cir. 2008).

[ix] *Emergent*, 343 F.3d at 197 (noting for both § 10(b) and common law fraud claims that, "if the loss was caused by an intervening event, like a general fall in the price of . . . stocks, the chain of causation will not have been established"); *McCabe*, 2006 U.S. Dist. LEXIS 524, at *45 (rejecting common law fraud and negligent misrepresentation claims because "chain [of causation was] broken . . . by a number of unforeseeable events, including . . . growth problems, industry issues, and mismanagement").

[x] *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 574 F.3d 29, 36 (2d Cir. 2009) (citation omitted).

[xi] *Id.* at *5 (*quoting Lentell*, 396 F.3d at 174).

[xii] *Id.* at *15.

[xiii] 2013 U.S. Dist. LEXIS 111979, at **3-4.

[xiv] *Id.* at *30.

[xv] *Id.* at **37-38.

[xvi] *Id.* at *38.

[xvii] *Id.*

[xviii] *Id.* at **4-5.

[xix] *Id.* at **1-2.

[xx] *Id.* at *48.

[xxi] *Id.* at **83-84 (emphasis added).

[xxii] *Id.* at *3.

[xxiii] *Id.* at *7 (emphasis in original); *see also id.* at *8 (citing report that "91% of U.S. CDO securities had been downgraded by the end of 2008" as a result of the credit crisis).

[xxiv] 963 N.Y.S.2d at 331-32.

[xxv] *Id.* at 332.