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Pleading & Proving Loss Causation in § 10(b) Credit Crisis Cases

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Class action plaintiffs lawyers appear to believe that loss causation will be easy to allege and prove in § 10(b) credit crisis cases, especially subprime/CDO cases, because stock prices dropped abruptly when companies announced write-downs. Not so fast. The combination of two major decisions—*Dura Pharmaceuticals, Inc. v. Broudo*[1] and *Bell Atlantic v. Twombly*[2]—should require a § 10(b) plaintiff in a subprime/CDO complaint, for example, to allocate such a stock price decline between the portions caused by alleged fraud occurring in earlier statements and the portions caused by non-fraud factors such as *subsequent* declines in the real estate and credit markets.[3] Specifically, under *Dura* and *Twombly*, in a credit crisis case, the complaint should allocate plausibly particular portions of a stock price's decline in response to a large write-down to (a) whatever smaller write-down allegedly should have been disclosed earlier; and (b) the subsequent and other reasons for the later, larger write-down.

Dura's Loss Causation Requirement

Dura requires a plaintiff to plead and prove "loss causation" in a § 10(b) case. The usual *Dura* issue is whether there was a corrective disclosure of a prior misstatement or omission in response to which there was a drop in the stock price.[4] *Dura* noted, however, that there are a "tangle of factors affecting [stock] price" that might affect the plaintiff's loss and that stock price declines from factors other than the alleged fraud do not satisfy loss causation.[5] *Dura* did not expressly address whether a plaintiff had to plead an allocation when both a misrepresentation and other factors may have caused portions of a stock price's decline.[6]

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***Dura* noted, however, that there are a "tangle of factors affecting [stock] price" that might affect the plaintiff's loss and that stock price declines from factors other than the alleged fraud do not satisfy loss causation.**

Requirements for Pleading and Proving Loss Causation Following *Dura* but Before *Twombly*

At later stages of a securities litigation, such as summary judgment and class certification, the plaintiff has been required to prove an allocation of a stock price's decline between fraud and non-fraud factors.[7] Following *Dura*, and before *Twombly*, however, the lower courts reached inconsistent results on whether a plaintiff must plead how a stock's decline should be allocated between contemporaneous fraud and non-fraud factors. The Second Circuit dismissed a claim against an auditor where the plaintiff did not sufficiently distinguish between declines from corrections of misstatements made by the issuer itself and declines from corrections of a narrower group of misstatements made by the defendant auditor.[8] The court noted that where the plaintiff did not "allege[] facts that would allow a fact finder to ascribe some rough proportion of the whole loss to [the defendant's] misstatements … [they] have not alleged loss causation."[9] Certain other courts, however, appeared to defer consideration of apportionment of multiple causes until after the motion to dismiss stage.[10]

Twombly

In *Twombly*, the Court addressed the general threshold for pleading a claim, stating that a complaint "requires a showing, rather than a blanket assertion, of entitlement to relief."[11] The Court added that the complaint must provide the "grounds on which the claims rest"[12] and factual allegations that "plausibly suggest[]" the facts that the plaintiff must ultimately prove, i.e., factual allegations that "possess enough heft to show that the pleader is entitled to relief."[13] Thus, "when the allegations in a complaint, however true, could not raise a claim of entitlement to relief," the complaint should be dismissed.[14] The Court explained that this higher threshold was necessary so that a complaint's "deficiency" may "be exposed at the point of minimum expenditure of time and money by the parties and the court."[15]

Lower Court Treatment of *Dura* and *Twombly* Together

Both *Dura* and *Twombly* emphasize that modern discovery burdens lead to waste, inefficiencies, and settlements driven not by the merits but by litigation costs. Thus, it is important to dismiss claims at the pleading stage that do not adequately plead the essential facts necessary to show the plaintiff is entitled to relief. In fact, *Twombly* cited the analysis in *Dura*, stating that "something *beyond the mere possibility of loss causation must be alleged*, lest a plaintiff with 'a largely groundless claim' be allowed to 'take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value.'"[16]

Lower courts have held that *Twombly*'s stricter pleading *standards* apply to securities litigation.[17] In particular, numerous courts have cited *Twombly* in opinions that dismiss complaints for inadequately pleading loss causation.[18] So far, however, none has addressed whether the combination of *Dura* and *Twombly* requires the complaint to allocate a stock price's decline between fraud and non-fraud causes.

Loss Causation Is Not Properly Alleged Where Market Forces Subsequent to a Defendant's Prior Alleged Misstatement Caused a Stock Price Decline

The requirements of *Dura* and *Twombly*, combined with earlier decisions granting motions to dismiss where stock price decreases are due to

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marketplace phenomena subsequent to a defendant's alleged fraud, show that courts should require allocation, including at the pleading stage, in cases involving credit crisis write-downs.

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The credit crisis is not the first economic crisis, nor will it be the last. Prior to *Dura*, the seminal decision of the Seventh Circuit in *Bastian v. Petren Resources Corp.*[19] addressed the effects of the substantial drop in oil prices in the early 1980s, noting that "[l]ike a stock-market crash, the collapse of oil prices reverberated throughout the economy."[20] *Bastian* held that a plaintiff improperly pled loss causation where a drop in the stock price was attributable to market forces subsequent to the defendant's misstatement. Indeed, *Bastian* held that "[i]f plaintiffs would have lost their investment regardless of the fraud, any award of damages to them would be a windfall."[21] Section 10(b) did not make defendants "insurers against national economic calamities"[22] that could be blamed for "industry-wide phenomena."[23] Thus, even defendants that made misrepresentations were not liable for stock declines resulting from a subsequent "change in market conditions."[24] The only exception would occur if a defendant made representations "that oil prices [would not] drop unexpectedly."[25] To our knowledge, no § 10(b) subprime/CDO class action defendant, or other § 10(b) credit crisis class action defendant, has been accused of representing that prices for subprime, CDO, or other debt securities held in the defendant's portfolio would not drop in the future.

More recently, on March 17, the Southern District of New York applied *Twombly* and *Dura* to grant a motion to dismiss a securities fraud claim and noted that "[w]hen the plaintiff's loss … 'coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases.'"[26] Thus, asset declines due to the impact of market forces subsequent to the defendant's alleged misrepresentation did not provide a basis for loss causation. Specifically, the defendant's March 9, 2006, Registration Statement for a Secondary Offering allegedly omitted a reduction in assets of an asset management company due to customer withdrawals from broker attrition.[27] On July 25, 2006, the defendant's press release announcing results for the quarter ended June 30, 2006, disclosed "$7 billion in client cash outflows … caused by a difficult market environment."[28] The court granted dismissal, holding that the announcement disclosing "client outflows" in the second quarter did not satisfy loss causation because that announcement "did not indicate that the outflows were occurring at the time of the Secondary Offering or were attributable to anything other than the market."[29]

Credit crisis cases also arise out of "marketwide phenomen[a]." The loss causation principles articulated in addressing prior economic crises should apply fully to § 10(b) credit crisis cases, including subprime/CDO cases.

Application of *Dura* to a Hypothetical Credit Crisis Case

Imagine Bank X should have disclosed exactly $100 million of subprime/CDO write-downs in July 2007 but omitted to do so. Later, Bank X discloses $2 billion of subprime/CDO write-downs in October 2007—*after* three additional months of deterioration in the subprime and credit markets—and its stock price drops from $50 to $40. That $10 per share loss should not be seen as the loss caused by the July omission. This is because the October 2007 disclosure of a $2 billion write-down after three additional months of market

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deterioration does not disclose that there should have been a much smaller $100 million write-down, or any write-down, three months earlier.

Imagine, nonetheless, that a § 10(b) class action plaintiff simply argues that the October 2007 $10 stock decline in the price of Bank's stock constitutes the loss caused by the July omission and allocates none of the decline to non-fraud factors. That would be insufficient under *Dura*. As lower courts have held in summary judgment and class certification decisions, a plaintiff is not entitled to relief under *Dura* unless it proves an allocation between the portion of the stock price decline caused by the alleged fraud (here, the failure to make a $100 write-down in July 2007) and the portion caused by other factors (here, the additional $1.9 billion write-down that is based on deteriorations in the subprime and CDO markets that occurred only *after* the July 2007 omission).[30]

The absence of loss causation is illustrated by comparing our subprime/CDO write-down hypothetical to a case where an issuer restates a prior quarter's revenue and the stock price immediately declines. In such a case, a plaintiff would allege that the disclosure in Quarter 2 reveals that the issuer's Quarter 1 representation of the very same facts—the issuer's earnings for Quarter 1—should have been lower by the amount of the misreported income. In contrast, a subprime/CDO write-down in October 2007 by Bank X does not reveal that Bank X should have disclosed a write-down of the same magnitude in July 2007. This is because the markets and economic data for subprime and CDOs worsened markedly from July to October 2007. Because of this "marketwide phenomenon," no one could plausibly suggest that a bank that correctly made a $2 billion subprime/CDO write-down in October 2007 should have made the same write-down in July 2007. Indeed, a large subprime/CDO write-down in October 2007 could be consistent with no write-down, or a small write-down, in July 2007. Thus, a large stock price decline in response to a large subprime/CDO write-down in October 2007 neither reveals that there was a prior misrepresentation in July 2007—much less the magnitude of such an alleged earlier misrepresentation—nor corrects any such earlier misrepresentation. Rather, in this hypothetical, the absence of a July 2007 write-down and the large October 2007 write-down address different, changed underlying facts. In those circumstances, *Dura* and its progeny hold there is no loss causation without an allocation.[31]

As lower courts have held in summary judgment and class certification decisions, a plaintiff is not entitled to relief under* Dura *unless it proves an allocation between the portion of the stock price decline caused by the alleged fraud … and the portion caused by other factors….

Application of *Twombly* to a Hypothetical Credit Crisis Case

The question under *Twombly* is this: when the plaintiff's failure to allocate a stock price's decline between fraud and non-fraud credit crisis factors would doom the plaintiff's case at the summary judgment or class certification stages, should the same failure nonetheless be permitted in the complaint? Under *Twombly*, the answer should be no. *Twombly* does not permit massive, wasteful discovery, and perhaps an unmerited settlement, when a plaintiff has not plausibly alleged an essential element of its own claim.

Under *Twombly*, when a stock price decline was caused at least in part by credit crisis factors other than the alleged misrepresentation, a complaint that does not allege facts showing a plausible basis for allocation of the decline between the fraud and non-fraud factors has not set forth allegations that are essential to raise a plausible claim of entitlement to relief. When the plaintiff has pled only the "the mere possibility of loss causation,"[32] because an essential element necessary for relief is omitted, the result should be dismissal under *Dura* and *Twombly*.[33]

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NOTES

1. *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 125 S. Ct. 1627, 161 L. Ed. 2d 577, Blue Sky L. Rep. (CCH) P 74529, Fed. Sec. L. Rep. (CCH) P 93218 (2005).
2. *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955, 167 L. Ed. 2d 929, 2007-1 Trade Cas. (CCH) ¶ 75709, 68 Fed. R. Serv. 3d 661 (U.S. 2007).
3. This memorandum addresses § 10(b) claims by shareholders in institutions that held large portfolios of subprime and CDO securities or other debt securities impacted by the credit crisis. It does *not* address claims under other provisions of federal securities law, such as §§ 11 and 12 of the Securities Act of 1933 or state law. Nor does it address claims by borrowers or by purchasers of subprime, CDO, or other debt securities that have declined due to the credit crisis. The views are those of the authors, not of Willkie Farr & Gallagher LLP or of any client of the firm.
4. 544 U.S. at 344.
5. *Id.* at 343. The court provides examples of the "tangle of factors," including "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." *Id.*
6. *Id.* at 342.
7. *See e.g., Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261, 270-71 (5th Cir. 2007) (vacating order of class certification because the plaintiff failed to provide "little more than well-informed speculation" and requires a "empirically-based showing that the corrective disclosure was more than just present at the scene"); *In re Omnicom Group, Inc. Securities Litigation*, 2008 WL 243788 at *8 (S.D. N.Y. 2008) (granting summary judgment "[b]ecause the law requires the disaggregation of confounding factors, disaggregating of only *some* of them cannot suffice to establish that the alleged misrepresentations actually caused Plaintiffs' losses") (emphasis in original); *In re Motorola Securities Litigation,* 505 F. Supp. 2d 501 (N.D. Ill. 2007) (granting defendant's summary judgment motion because "the causal link between the concealed [fraud] and the share price decline … is simply too tenuous to satisfy loss causation").
8. *Lattanzio v. Deloitte & Touche LLP,* 476 F.3d 147, Fed. Sec. L. Rep. (CCH) P 94150 (2d Cir. 2007).
9. *Id.* at 158.
10. *See, e.g., In re DRDGOLD Ltd. Securities Litigation*, 472 F. Supp. 2d 562, Fed. Sec. L. Rep. (CCH) P 94151, Fed. Sec. L. Rep. (CCH) P 94316 (S.D. N.Y. 2007) (stating that "[w]hether it was in fact other openly disclosed risks that caused the drop in price in the stock is 'a matter for proof at trial and not to be decided on a 12(b)(6) motion to dismiss'" (*quoting Emergent Capital Inv. Management, LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197, Fed. Sec. L. Rep. (CCH) P 92497 (2d Cir. 2003)); *Ong ex rel. Ong v. Sears, Roebuck & Co.*, 459 F. Supp. 2d 729, 748-49 (N.D. Ill. 2006) (noting that "[t]he Seventh Circuit does not require a plaintiff to affirmatively rule out those other factors [that affected share price] in its complaint; rather, that burden arises at trial").
11. *Twombly,* 127 S.Ct. at 1964 n.3.
12. Id.
13. *Id.* at 1966.
14. Id.
15. Id.
16. 127 S.Ct. at 1966 (quoting *Dura,* 544 U.S. at 347) (emphasis added).
17. *See e.g., ATSI Communications, Inc. v. Shaar Fund, Ltd.,* 493 F.3d 87, 98 n.2, Fed. Sec. L. Rep. (CCH) P 94363 (2d Cir. 2007) (applying *Twombly*'s pleading requirement to a securities litigation matter and stating "[w]e have declined to read *Twombly's* flexible 'plausibility standard' as relating only to antitrust cases"); *In re Cyberonics Inc. Securities Litigation,* 523 F. Supp. 2d 547, Fed. Sec. L. Rep. (CCH) P 94453 (S.D. Tex. 2007) (citing *Twombly* as part of the "standard of review" and dismissing a securities fraud claim for failure to properly plead scienter); *In re Coca-Cola Enterprises Inc. Securities Litigation*, 2007 WL 2904160, *2 (N.D. Ga. 2007) (dismissing plaintiff's securities fraud complaint and stating "in the post-Reform Act and post- *Twombly* world, the Plaintiffs' case lacks sufficient plausibility to survive"); *Garber v. Legg Mason, Inc.,* 2008 WL 697638, *7 (S.D.N.Y. 2008) (dismissing § 10(b) action and adopting the *Twombly* "plausibility" requirement that a "pleading [must] allege[] 'enough facts to state a claim for relief that is plausible on its face.'" (quoting *Patane v. Clark*, 508 F.3d 106, 111-12, 227 Ed. Law Rep. 549, 102 Fair Empl. Prac. Cas. (BNA) 171, 90 Empl. Prac. Dec. (CCH) P 43025 (2d Cir. 2007)). *But see Kersenbrock v. Stoneman Cattle Co.*, LLC, 65 Env't. Rep. Cas. (BNA) 2016, 2007 WL 2219288, *2 n.2 (D. Kan. 2007) (restricting *Twombly's* analysis to antitrust cases).
18. *See, e.g., ATSI Comm., Inc.,* 493 F.3d at 107 (dismissing a claim because the plaintiff failed to "establish any causal connection between those losses [resulting from the decline in stock price]

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and the misrepresentation"); *In re AOL Time Warner, Inc. Securities Litigation*, 503 F. Supp. 2d 666, 678-79 (S.D. N.Y. 2007) (dismissing a claim as to a particular disclosure because the plaintiff failed to plead loss causation by not providing in their complaint "a nexus between the alleged fraud and their losses, either by demonstrating the materialization of a concealed risk or the existence of a corrective disclosure"); *In re Coca-Cola Enterprises Inc. Securities Litigation*, 2007 WL 2904160, at *3 (N.D. Ga. 2007) (dismissing § 10(b)(5) claim because plaintiffs did not "set forth a sufficient nexus" between the alleged fraud and a press release disclosure); *Glenbrook Capital Ltd. Partnership v. Kuo*, 525 F. Supp. 2d 1130, Fed. Sec. L. Rep. (CCH) P 94470 (N.D. Cal. 2007) (applies *Twombly* standard and states that the "plaintiff has not pleaded facts establishing the necessary direct link between particular omissions by defendants and the decrease in the stock price"); *In re Buca Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) P 94395, 2007 WL 2509716, *4 (D. Minn. 2007) (applying *Twombly* and dismissing complaint for "not sufficiently plead[ing] loss causation"); *Congregation of Ezra Sholom v. Blockbuster, Inc.*, 504 F. Supp. 2d 151, 168, Fed. Sec. L. Rep. (CCH) P 94467 (N.D. Tex. 2007) (applying *Twombly,* and holding that plaintiffs failed to adequately plead loss causation where disclosure "did not explicitly correct a prior misrepresentation or provide previously undisclosed material facts or risks that proximately caused the loss for which Plaintiffs seek damages"); *Cordova v. Lehman Bros., Inc.*, 526 F. Supp. 2d 1305, Fed. Sec. L. Rep. (CCH) P 94534 (S.D. Fla. 2007) (dismissing claim because of a failure to sufficiently plead loss causation as *Twombly* requires "'more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do'") (quoting *Twombly,* 127 S.Ct. at 1964-65); *In re Intelligroup Securities Litigation*, 527 F. Supp. 2d 262 (D.N.J. 2007) (holding that Plaintiffs failed to sufficiently plead loss causation because they did not show a connection between the alleged fraud and the stock price decline).

19. *Bastian v. Petren Resources Corp.,* 892 F.2d 680, Fed. Sec. L. Rep. (CCH) P 94908, R.I.C.O. Bus. Disp. Guide (CCH) P 7406 (7th Cir. 1990).
20. 892 F.2d at 685 (emphasis added); *see also Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447, Fed. Sec. L. Rep. (CCH) P 99487 (11th Cir. 1997) (dismissing claim for failure to plead loss causation and noting that "market responses, such as stock downturns, are often the result of many different, complex, and often unknowable factors" and that "10b-5 [should not] becom[e] a system of investor insurance that reimburses investors for any decline in the value of their investments").
21. *Id.* at 684-85.
22. *Id.* at 685.
23. Id.
24. Id.
25. *Id.* at 686.
26. *Garber v. Legg Mason, Inc.*, 537 F. Supp. 2d 597 (S.D. N.Y. 2008) (quoting *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 174 (2d Cir. 2005)).
27. *Id.* at *5.
28. *Id.* at *6.
29. *Id.* at *15.
30. *See supra*, n. 7.
31. *See supra*, nn. 5, 7.
32. *Twombly,* 127 S.Ct. at 1966 (citing *Dura,* 544 U.S. at 347).
33. *But cf. In re Xethanol Corp. Securities Litigation,* 2007 WL 2572088, *2 n.2 (S.D. N.Y. 2007) (references *Twombly* standard but notes that "since loss causation is a fact-based inquiry generally, and particularly here where the alleged loss was caused by the general fall in the price of Xethanol's stock, it is not an appropriate issue to be decided on a motion to dismiss"); *Hunt v. Enzo Biochem, Inc.*, 530 F. Supp. 2d 580 (S.D. N.Y. 2008) (cites *Twombly* but finds that loss causation was sufficiently pled even though, based on the facts, Plaintiff may not have allocated between fraud and non-fraud factors). There was, however, apparently no allocation issue raised in *Xethanol* or *Hunt* by the defendants.

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