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Securities Litigation Arising Out of the Financial Crisis: A Survey of Relevant Decisions and Their Implications

by Kathleen N. Massey

It should come as no surprise, given the financial crisis that began in early 2007, that there has been a dramatic increase in the number of securities class action filings.[1] Defendants and potential defendants—and who in the financial services industry is not a potential defendant?—are looking for insights into how to avoid expensive and burdensome securities claims and how to defend against such claims once they are asserted.

Recent decisions in the area are beginning to provide some answers to these questions. Defendants are most likely to succeed at an early stage when plaintiffs do not, or cannot, properly allege material misrepresentations or scienter. Attacks on allegations of loss causation have been less crucial to decisions thus far, but should remain important in the long run. Thus, to avoid litigation, it is critical to ensure that disclosures about the risks associated with particular securities are complete and accurate, accompanied when appropriate with cautionary language. Equally important, it is necessary to pay attention to red flags that suggest there are risks that have not been adequately disclosed and to take appropriate corrective action to address any such risks. And once litigation has begun, careful scrutiny of the plaintiff's allegations in the key areas of material misrepresentations, scienter, and loss causation may lead to motions that will end such litigation relatively quickly.

Summary of Litigation Arising Out of the Financial Crisis

As discussed in detail below, a review of complaints arising out of the financial crisis demonstrates that the claims have evolved over the past

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few years, from those involving individuals suing local lenders under state law for reasons relating to their personal mortgages, to sophisticated investors bringing class actions under the federal securities laws against large institutions in the financial services industry. Although investors of all sorts have suffered substantial losses recently, and understandably would like to recover from someone, several courts have recognized that recovery is not appropriate where the claim is really just about declining investments "in a volatile industry at the onset of a long, destructive economic downturn."[2]

The decisions rendered to date in cases arising out of this downturn indicate that defendants have been most successful in defeating claims when plaintiffs have failed to allege adequately that defendants' disclosures were materially misleading or that defendants acted with wrongful intent. Based on those decisions and others concerning federal securities and corporate governance law, the resolution of the hundreds of cases yet to be decided also likely will be based on the foregoing grounds as well as based on failures by plaintiffs to allege or establish that wrongdoing by defendants was the proximate cause of investor losses.

Background

Leading up to the current surge in securities class action litigation, the cases initially filed concerned subprime loans and securitizations of those loans. The earliest cases in this area were brought by individual borrowers facing foreclosure who claimed, based largely on state law, that they had been deceived by mortgage lenders and their agents, resulting in borrowers taking on payment obligations they were unable to satisfy, particularly in the context of depreciating home prices.[3] As the real estate crisis spread, borrowers across the country defaulted on their mortgage loans and real estate values plummeted, plaintiffs' class action lawyers jumped into the fray and filed federal class actions alleging that mortgage lenders engaged in fraudulent schemes to push borrowers into subprime loans that were then sold as investments in the secondary mortgage market.[4]

As the crisis spread from subprime real estate to collateralized debt obligations related to subprime debt generally, investors who had acquired interests in securitized products began pursuing relief in the courts as well. Some investors claimed that their interests in securitized products were impaired as a result of defaults on subprime credit card debt.[5] Other investors sued based on losses incurred in investments based on subprime automobile loans.[6]

Plaintiffs quickly broadened their focus to include entities generally involved in the real estate and related lending businesses. Investors in those entities brought suit under the federal securities laws alleging that they had been misled about the value of those companies by misrepresentations about the quality of loans originated by defendants, losses on those loans, compliance with underwriting guidelines, internal controls, and risk management systems. For example, shareholders have brought class action litigation claiming they overpaid for stock in a publicly-traded mortgage lender that overstated the quality of the loans it made.[7] Shareholders have brought numerous class actions based on alleged misrepresentations by an entity involved with originating, purchasing, investing in, servicing, and securitizing mortgages.[8] Plaintiffs also filed class actions against rating agencies, and insurance companies involved in insuring collateralized debt obligations, alleging that defendants misrepresented their financial health.[9]

As the subprime crisis became a widespread credit crisis, plaintiffs also brought suit against entities in the financial services industry generally. For example, shareholders in investment companies have sued to recover losses arising from the funds' investments in collateralized debt obligations and other securities impacted negatively by the financial crisis. Investors in large financial institutions have filed hundreds of class actions claiming they acquired debt and equity securities issued by such institutions in reliance on misrepresentations and omissions about a wide range of issues, including the risks associated with the issuers' investments in collateralized debt obligations. Substantive decisions have yet to be rendered in most of these actions.

Claims under the Federal Securities Laws

Many of the most recent cases naming financial institutions as defendants have been based on alleged misrepresentations and have involved claims asserted under the federal securities laws, including, in particular, Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated thereunder.[10] The alleged misrepresentations that generally form the basis for these claims relate to the nature of defendants' investments, the risks associated with those investments, hedging practices, internal controls, and risk management systems.

To establish a claim for misrepresentation or omission of a material fact, under Section 10(b), a plaintiff is required to prove that, in connection with the purchase or sale of a security, defendant made an untrue statement of a material fact, with scienter, upon which plaintiff relied and that plaintiff sustained damages as a result of such reliance.[11] As discussed below, a survey of decisions rendered thus far in the context of subprime lending and the credit crisis indicates that defendants have been successful in defending against claims under Section 10(b) on the grounds that plaintiffs have failed to allege material misrepresentations or omissions and intent to defraud with the requisite particularity. Relevant case law also suggests that defendants should be successful in defending against claims on the grounds that plaintiffs cannot establish that any alleged misrepresentations or omissions were the proximate cause of plaintiffs' losses.

Failure to Allege Fraud with Particularity

Under the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act of 1995 (PSLRA), a plaintiff is required to plead facts in support of a Section 10(b) claim with particularity, including, among other things, facts that indicate what the alleged misrepresentation or omission of fact was and why it was false.[12] It is well established that where a plaintiff fails to allege a misrepresentation or omission of fact with particularity, a claim will be dismissed. This remains true in the context of the financial crisis.

For example, in a case against defendants involved in the management or offering of two funds whose investment strategies focused on managed portfolios of subprime automobile loans, the court rejected arguments by plaintiffs that defendants misrepresented or failed to disclose risks associated with the secondary market for the loans.[13] The court found that plaintiffs failed to allege why statements in the offering memoranda about the funds' investments and the secondary market for those loans were false.[14] Similarly, in a class action complaint alleging misrepresentations about the quality of a public company's loan portfolio and its underwriting practices, the court dismissed plaintiffs' claims on the grounds that plaintiffs failed to allege the "who, what, when, where, and how" as required.[15]

Other claims under Section 10(b) have been disposed of on the grounds that they were not based on misrepresentations or omissions of fact but were instead based on non-actionable puffery. Statements of hope, opinion, or belief about the future performance of a company or the market generally cannot form the basis of a fraud claim.[16]

Failure to Allege Materiality

Although materiality is frequently an issue that is not decided at the motion to dismiss stage of a case, there are certain circumstances in which courts will dismiss securities fraud complaints for failure to plead materiality. For example, courts likely will decide that certain alleged misrepresentations are immaterial as a matter of law under the "bespeaks caution doctrine" if it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language in the disclosure.[17] Similarly, courts likely will dismiss cases based on statements that are protected under a statutory safe harbor for forward-looking statements, which applies to certain projections and other statements of future economic performance, if the statements are identified as forward-looking, accompanied by meaningful cautionary language and not made with actual knowledge that they are false or misleading.[18]

Failure to Allege Scienter with Particularity

In addition to pleading a misrepresentation or omission of fact, a plaintiff seeking to recover under Section 10(b) must allege that a defendant acted or failed to act with scienter, which is the intent to deceive, manipulate, or defraud.[19] Under the PSLRA, a plaintiff must plead facts that give rise to a strong inference that the defendant acted with the required state of mind.[20] "[I]n determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences."[21] For an inference of scienter to be strong, "a reasonable person [must] deem [it] cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[22]

To plead scienter, plaintiffs are generally required to allege facts showing that defendants had the motive and opportunity to deceive, or that there is strong circumstantial evidence of conscious misbehavior or recklessness. In cases arising out of the subprime and ensuing financial crisis, plaintiffs have generally argued that their allegations show conscious misbehavior or recklessness, which requires allegations that defendants knew facts or had access to information contradicting their public statements or that defendants ignored red flags indicating that their disclosures were misleading.

Recent decisions have tended to find plaintiffs' allegations lacking in this area. Mere allegations that defendants should have anticipated future events and should have made certain disclosures earlier than they did do not suffice.[23] For example, in a case brought as a purported class action against a publicly-traded mortgage lender and its officers, the court granted defendants' motion to dismiss claims that the company's stock was artificially inflated on the grounds that plaintiffs' vague allegations about defendants' lending practices were insufficient to plead a strong inference that defendants acted with wrongful intent or recklessly.[24]

In another case involving claims for failure to disclose risks relating to subprime lending, which was brought under Delaware corporate law but raises issues analogous to those at issue in evaluating scienter in a Section 10(b) case, the court rejected plaintiffs' arguments that defendants knew or should have known about risks of loss from subprime lending.[25] Public reports about the declines in the housing market, the failure of several large subprime lenders, and the substantial losses reported by certain large financial institutions were found not to constitute red flags that should have put defendants on notice of problems in the subprime market. The court held that plaintiffs could not establish that defendants had failed to disclose risks knowingly or in bad faith, recognizing that the company had procedures and controls in place designed to monitor risk.[26] Most significantly, the court held that defendants should not be held liable for failing to predict the future or for failing fully to recognize the risks posed by subprime securities.[27]

Failure to Allege Loss Causation

Pursuant to the PSLRA, a plaintiff seeking to establish a claim under Section 10(b) has the burden of proving that the act or omission of the defendant caused the loss for which the plaintiff seeks to recover damages.[28] The plaintiff cannot simply allege that it overpaid for a security because its price was inflated, but must prove that the misrepresentation itself proximately caused the economic loss.[29] In other words, a plaintiff must allege that "the *subject* of the fraudulent statement or omission . . . was the cause of the actual loss suffered, *i.e.*, that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security."[30] (This is to be distinguished from "transaction causation," which simply means that the plaintiff would not have entered into the transaction in question but for the defendant's misrepresentation.)

Although courts deciding cases arising out of the financial crisis have tended to find that plaintiffs have sufficiently pled corrective disclosures and resulting losses, it has been held that plaintiffs cannot satisfy the pleading requirements by alleging simply that they purchased securities in reliance on misrepresentations and then suffered a loss when they sold.[31]

Some defendants have sought dismissal on the grounds that losses were not caused by corrective disclosures, but were instead caused by an intervening cause, such as an industry-wide downturn. Although one court was willing to consider that argument seriously, the court found the argument did not work in that case because there were insufficient indicia of an industry-wide downturn given that the stock prices of the company's competitors did not fall along with the company's.[32]

However, the argument should work under different circumstances, as it did in a case arising out of the bursting of the dotcom bubble. That case involved alleged failures to disclose the risk of price volatility, and defendants succeeded in defeating Section 10(b) claims on the grounds that plaintiffs failed to allege that corrective disclosures resulted in plaintiffs' loss, the allegedly undisclosed risk was apparent on the face of the disclosures alleged to conceal the risk and plaintiffs failed to allege facts sufficient to support an inference that it was defendants' fraud—rather than the industry-wide downturn—that proximately caused plaintiffs' loss.[33]

Conclusion

Based on what can be gleaned from the early decisions in the subprime and credit crisis area and what recent securities fraud actions and derivative actions teach, it is clear that to avoid litigation potential defendants must ensure that their disclosures about the risks associated with particular securities are complete and accurate and accompanied by appropriate cautionary language. Potential defendants also should pay attention to red flags that potential risks have not been disclosed adequately and take appropriate action to address any such risks.

Once litigation arises, some arguments are more likely than others to be successful at putting a relatively early stop to costly and burdensome litigation. Defendants should, as a priority, examine whether plaintiffs have failed to allege material misrepresentations and wrongful intent with the requisite particularity; defendants may also have success in arguing in some cases that plaintiffs cannot establish loss causation. All defendants and potential defendants, that is, everyone in the financial services industry, should pay close attention to further developments in the hundreds of pending actions arising out of the financial crisis, which will surely shed additional light on these issues over the next several years.

NOTES

1. According to recent reports, the number of securities class actions filed in 2008 was at its highest level since 2004, and there were at least 576 cases filed in 2008 relating to subprime mortgages and related issues. Cornerstone Research, "Securities Class Action Filings—2008: A Year in Review," (2009) (*available at http://securities.cornerstone.com/pdfs/YIR2008.pdf*); Grace Lamont & Patricia A. Etzold, Price Waterhouse Coopers, "2008 Securities Litigation Study" (2009); Jeff Nielsen et al., Navigant Consulting, "Subprime Mortgage and Related Litigation—2008: Seeking Relief" (2009) (*available at http://www.navigantconsulting.com/downloads/knowledge_center/Navigant_2008_Credit_Crisis_Litigation_Report_Exec_Summary_Mar-09.pdf*).

2. Pittleman v. Impac Mortgage Holdings, Inc., No. SACV 07-0970, 2009 WL 648983, at *4 (C.D. Cal., Mar. 9, 2009).

3. *See, e.g.*, Graupner v. Select Portfolio Servicing, No. B196401, 2009 WL 428578, at *1 (Cal. Ct. App. 2d, Feb. 23, 2009) (describing plaintiffs as "early victims of the subprime mortgage debacle").

4. *See, e.g.*, In re Countrywide Fin. Corp. Mortgage Marketing & Sales Practices Litig., Nos. 08MD1988, 08CV1888, 08CV1957, 08CV1972, 2009 WL 458780 (S.D. Cal., Feb. 5, 2009) (involving claims for alleged violation of the Racketeer Influenced and Corrupt Organizations Act and state law claims).

5. *See* Bank of New York v. First Millennium, Inc., No. 06 Civ. 13388, 2009 WL 453404 (S.D.N.Y., Feb. 24, 2009) (involving competing breach of contract claims for funds held in a trust created as part of the securitization of credit receivables owed in part by subprime borrowers).

6. *See* Edison Fund v. Cogent Inv. Strategies Fund, Ltd., 551 F. Supp. 2d 210, 216 (S.D.N.Y., 2008) (involving claims under the federal securities laws and state law).

7. *See, e.g., Pittleman*, at *1 (involving claims of stock price inflation under Sections 10(b) and 20(a) of the Exchange Act).

8. *See, e.g.*, In re Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132 (C.D. Cal., 2008); In re Countrywide Fin. Corp. Derivative Litig., 554 F. Supp. 2d 1044 (C.D. Cal., 2008).

9. *See, e.g.*, In re Moody's Corp. Sec. Litig., No. 07 CV 8375, 2009 WL 435323 (S.D.N.Y., Feb. 23, 2009) (involving claims under Section 10(b) and 20(a) for misrepresentations about Moody's independence and rating methodologies).

10. Plaintiffs also have brought suit under Section 20 of the Exchange Act, Sections 11, 12, and 15 of the Securities Act of 1933 and even under Section 13(a) of the Investment Company Act of 1940. *See* Northstar Fin. Advisors, Inc. v. Schwab Invs., No. C 08-4119, 2009 WL 415616 (N.D. Cal., Feb. 19, 2009). Other cases arising out of the financial crisis have been based on claims for breach of contract, breach of fiduciary duty and violation of other state laws, as well as violations of the Racketeer Influenced and Corrupt Organizations Act and the Employee Retirement Income Security Act.

11. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5(b); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–342 (2005).

12. Fed. R. Civ. P. 9(b); 15 U.S.C. § 78u-4(b)(1).

13. *See Edison Fund*, at 220–223.

14. *Id.* at 221–223.

15. *See* In re Downey Sec. Litig., No. CV 08-3261, 2009 WL 736802, at *7 (C.D. Cal., Mar. 18, 2009).

16. *See id.* at *6.

17. *Edison Fund*, at 223–224.

18. 15 U.S.C. § 77z-2(c)(1).

19. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 127 S. Ct. 2499, 2504 (2007).

20. 15 U.S.C. § 78u-4(b)(2).

21. *Tellabs*, at 2509.

22. *Id.* at 2510.

23. *See Edison Fund*, at 228.

24. *Pittleman*, at *3–4.

25. *See* In re Citigroup Inc. Shareholder Derivative Litig., 964 A.2d 106, 134–135 (Del. Ch. 2009).

26. *Id.* at 127–131.

27. *Id.* at 131.

28. 15 U.S.C. § 78u-4(b)(4).

29. *Dura Pharm.*, at 345–346.

30. Lentell v. Merrill Lynch & Co., 396 F.3d 161, 173 (2d Cir. 2005) (internal citation and quotation marks omitted).

31. *See Edison Fund*, at 229–230.

32. *See In re Moody's*, at *15–16.

33. *See Lentell*, at 172–177.

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