# Recession-Era Loss Causation: Disentangling Under Dura

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Law360, New York (March 04, 2013, 11:33 AM ET) -- The element of loss causation has been an important battleground in lawsuits brought by plaintiffs seeking to recover investment losses under Section 10(b) of the Securities Exchange Act of 1934. This trend has continued as courts work their way through cases related to the financial crisis of 2007 and 2008, where the causes of claimed losses are uncertain given the impact of the crisis.

Loss causation is an element of Section 10(b) and is codified in the Private Securities Litigation Reform Act.[1] It derives from the tort concept of proximate cause, and requires not only that a claimed loss be foreseeable but also that the plaintiff prove that the alleged fraud in fact caused the particular loss for which the plaintiff seeks to recover.[2]

Loss causation applies both to fraud and nonfraud claims and is distinct from the transaction causation element or reliance, which requires a showing that, but for an alleged misstatement, plaintiff would not have entered into the transaction. While the global financial crisis spurred an avalanche of litigation, recent decisions have also highlighted potential obstacles to recovery for plaintiffs who are unable to provide particularized proof that their losses were caused by a defendant's alleged misconduct, and not the crisis itself.

The loss causation element was more recently addressed by the Supreme Court in *Dura Pharmaceuticals Inc.* v. *Broudo*, before the financial crisis erupted. In Dura, the Supreme Court noted that there may be a "tangle of factors affecting price," signaling to lower courts that plaintiffs must show that their loss was particularly caused by the alleged misstatements.[3]

In 2009, the Second Circuit interpreted the principle of the "tangle of factors affecting price" as requiring plaintiffs to "disaggregate those losses caused by 'changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events from disclosures of the truth behind the alleged misstatements."[4] Defendants have successfully employed this interpretation to argue that plaintiffs failed to disentangle their claimed losses from those caused by general market-wide phenomena.[5] Consistent with this rationale, Second Circuit law "precludes assigning two different causes to the same quantum of loss."[6]

Arguments focused on post-Dura "disaggregation" may take different forms depending on the stage of litigation and specific claims involved, and have typically involved an "event study" which compares the performance of a disputed investment to a market benchmark against which the impact of the alleged fraud can be measured over a focused period of time. When that period of time also involves substantial market disruptions, event study analysis becomes particularly challenging, and concurrent declines in the benchmark can lead to substantial reductions to recoverable losses. For plaintiffs, a plausible but uncertain claim that at least some losses were caused by fraud may be insufficient, and the burden of proof takes on greater importance.

The Second Circuit recently hinted that loss causation principles could result in the elimination of any recovery for losses that cannot be distinguished from "the global financial crisis" and related factors. In *NECA-IBEW Health & Welfare Fund* v. *Goldman Sachs & Co.*, the court identified a number of factors that plaintiff would have to isolate in order to demonstrate a re-coverable loss, including liquidity, credit risk and a widening of spreads. The court noted that the depressive impact of these confounding factors "does not prevent a damages expert from isolating their respective contributions."[7]

Several courts have entertained this kind of disaggregation analysis at the pleading stage. In *Solow* v. *Citigroup Inc.*, for instance, the court observed that losses coinciding with the mortgage-based market meltdown could be attributed to a "lack of confidence" in the firm, rather than to a materialization of the risk allegedly concealed by defendants.

There, the pleadings alleged a series of events and corresponding percentage declines in stock values on the days following the events. The court held that plaintiffs did not sufficiently allege loss causation because they failed to link the events to the alleged misstatements themselves rather than to a general lack of confidence on the part of investors.[8] Thus, plaintiffs must not only disentangle a company's loss from market wide phenomena, but also attribute the loss to the specifically alleged actionable misrepresentations.

Defendants have also successfully used loss causation to defend against claims under the Securities Act of 1933. In a Section 11 claim, defendants can assert loss causation as an affirmative defense if they can demonstrate that their alleged wrongdoing did not, in fact, cause the plaintiffs' losses. In In re State Street Bank and Trust Co. Fixed Income Funds Investment Litigation, for example, the court, examining a Section 11 claim involving a mutual fund, recognized that since the mutual fund price was set according to a statutory formula, it could not have been artificially inflated on account of alleged misstatements concerning the fund's diversification and exposure to the mortgage-related securities market.[9]

In re State Street can be read to stand for the proposition that where there is but one fixed determinant of stock price, (e.g., a statutory formula), rather than a "tangle" of factors, courts must thoroughly scrutinize the allegation that a materialization of the risk caused a decline in stock value, and defendants have a potential argument for negative causation on a motion to dismiss.

Event studies have become an indispensable tool in showing or refuting loss causation in securities litigation at summary judgment or trial. While plaintiffs have not been required to assign a quantum to the fraud-related loss at the pleading stage, they are nonetheless obligated to "ascribe some rough proportion" of their loss to the alleged misstatements.[10]

The requirement is logical: a lawsuit is not a "downside insurance policy" against losses attributable to general market declines.[11] This has traditionally been a difficult element of proof for plaintiffs even when markets were strong. Where a dramatic market downturn causes significant losses and itself has many large-scale causes ascribed to it, defendants may point to these complications to reduce or even eliminate recovery.

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[1] 15 U.S.C. § 78u–4(b)(4) (2012) ("[T]he plaintiff shall have the burden of proving that the act or omission of the defendant . . . caused the loss for which plaintiff seeks to recover damages.").

[2] Lentell v. Merrill Lynch & Co., Inc., 396 F.3d 161, 173 (2d Cir. 2005) (requiring "both that the loss be foreseeable and that the loss be caused by the materialization of the concealed risk").

[3] Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 343 (2005).

[4] In re Flag Telecom Holdings, Ltd. Securities Litigation, 574 F.3d 29, 36 (2d Cir. 2009).

[5] See, e.g., Wilamowsky v. Take-Two Interactive Software, Inc., 818 F. Supp. 2d 744, 756-57 (S.D.N.Y. 2011) (recognizing a court's "obligation to analyze" loss causation pleadings and finding that "[t]he obvious inference derived from these varied stock reactions is that the . . . price movement . . . was caused by the broad 'tangle' of non-culpable . . . information").

[6] In re Flag Telecom Holdings, Ltd., 574 F.3d at 37 (quotations omitted).

[7] NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co., 693 F.3d 145, 167 & n.15 (2d Cir. 2012).

[8] Solow v. Citigroup, Inc., No. 10 Civ. 2927, 2012 WL 1813277, at *9 (S.D.N.Y. May 18, 2012).

[9] In re State Street Bank and Trust Co. Fixed Income Funds Investment Litigation, 774 F. Supp. 2d 584, 594-95 (S.D.N.Y. 2011).

[10] Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147, 158 (2d Cir. 2007); see also Wilamowsky, 818 F. Supp. 2d at 757 (recognizing a court's duty to "analyze whether a pleading contains sufficient factual content ... to draw the reasonable inference that the defendant is liable for the misconduct alleged" (quotations omitted) (emphasis added)).

[11] Dura, 544 U.S. at 347-48.

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