New York Law Journal
A NEW YORK LAW JOURNAL SPECIAL SECTION
Litigation
An ALM Publication
WWW.NYLJ.COM
MONDAY, JULY 14, 2014

# Pleading **Fraud** With **Particularity**

BIGSTOCK

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Widespread losses suffered by many investors during the financial crisis have spawned more than a few fraud claims based upon broadly alleged misconduct affecting many investments or transactions, and even entire lines of business.[1] Complaints have sought to portray defendants as rife with fraud, and invite an inference that plaintiff's losses are an inescapable part of that portrait. The loosely proffered connection to the plaintiff's own loss, however, has in turn led defendants to argue that such widespread claims lack a particular connection to the plaintiff's investment even if they are assumed to be true. Under Federal Rule of Civil Procedure 9(b), plaintiffs must allege fraud with particularity—a standard traditionally met by alleging the specifics of "who, what, when, where and how."[2] Recent cases suggest opportunities for successful arguments on both sides of this contentious issue.

**Two Recent Decisions.** Two Southern District of New York decisions *Dexia SA/NV v. Bear, Stearns & Co.*[3] and *Woori Bank v. Citigroup*[4] illustrate the tension. In *Dexia*, an investor sued defendants for fraud in connection with its purchase of $1.6 billion dollars in residential mortgage-backed securities (RMBS). The investor alleged the relevant offering documents made false representations regarding the quality and selection process of the underlying loans. In support of its complaint, it cited evidence of defendants' allegedly systematic disregard of underwriting standards and due diligence practices but offered no evidence directly relevant to the RMBS at issue. Defendants moved to dismiss the complaint pursuant to Rule 9(b), arguing that the complaint failed to allege fraud with particularity because plaintiff did not plead a connection between the wrongful conduct alleged and the specific RMBS it purchased. Judge Jed S. Rakoff denied defendant's motion, holding that plaintiff's allegations in the complaint "present a picture of defendants' unsound mortgage origination and securitization practices so pervasive that a reasonable fact-finder could infer that those practices affected the securitizations at issue in this case."[5]

Meanwhile, in *Woori* an investor brought fraud claims against defendant for misrepresenting the values and risks associated with $95 million of collateralized debt obligations (CDOs) it purchased. In its complaint, plaintiff made generalized allegations about defendant's practices as they pertained to its entire CDO practice, claiming that defendant stated its RMBS and CDOs were "high grade" or "investment quality" despite knowing that they contained "bad quality" or "toxic" assets. As in *Dexia*, there were no allegations directly relevant to the CDOs at issue. And as in *Dexia*, defendants moved to dismiss the complaint pursuant to Rule 9(b) for failure to allege fraud with particularity. But, unlike in *Dexia*, Judge Laura T. Swain dismissed the complaint. The court acknowledged that the complaint "[painted] a general picture of a business group allegedly

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engaging in various forms of serious misconduct that would call into question the integrity of its business operations," but noted plaintiff "fail[ed] to identify specific statements or to provide information linking Citigroup's alleged practices with Woori's actual purchases."[6] The court also noted that "[t]he law of fraud and Rule 9(b) do not, however, embrace claims founded on such atmospherics. Rather, fraud [p]laintiffs must specify allegedly fraudulent statements and proffer specific factual allegations demonstrating their falsity in the context of the particular situation from which the claim arises."[7]

Each case directly addressed an investor's effort to satisfy Rule 9(b) requirements with respect to allegations of generally improper business practices. Typical of many recent financial crisis cases, both claims asserted that reports from the same due diligence vendor Clayton Holdings should have made the defendants aware of the allegedly widespread fraud. In *Dexia*, Rakoff took the view that the plaintiff had detailed the alleged widespread business practices with particularity. Because the scope of misconduct detailed in the complaint was asserted to be "so pervasive," the court reasoned it is reasonable to infer that the alleged practices tainted the investment at issue. In *Woori*, Swain reached the opposite conclusion that generalized allegations about widespread business practices asserted in that case were missing a clear connection to plaintiff's loss, and that "[t]he law of fraud and Rule 9(b) do not, however, embrace claims founded on such atmospherics."[8] Somewhere in between these two decisions there must be a basis upon which to distinguish between claims for losses occurring in an "atmosphere" of fraud and claims for losses that can be traced with some specificity to a particularly alleged practice.

**Rule 9(b) and the Connection Between the Loss and the Alleged Practice.** Although a traditional focus for a loss causation analysis, a key factor in the Rule 9(b) assessment in both cases appears to be the particular details that purport to connect the improper practices alleged to the plaintiff's loss. As both opinions suggest, an analysis of allegedly proximate connections typically required to show loss causation will have obvious relevance to the heightened requirements of Rule 9(b) where a plaintiff asserts that broadly alleged practices harmed that plaintiff particularly.

In support of the dismissal they obtained, the defendants in *Woori* advocated a focus on the plaintiff's failure to offer any particular details that connected the injury it suffered to the alleged misconduct. "Woori has not alleged any connection between these [fraud] allegations and the five CDOs it purchased from Citigroup."[9] The defendants in *Woori* thereby successfully argued that Rule 9(b) requires a particularized nexus between the alleged misconduct and the loss suffered by the plaintiff—a loss-causation-like analysis. In general, loss-causation requires that "the damages suffered by plaintiff … be a foreseeable consequence of any misrepresentation or material omission."[10] The court in *Dexia*, in contrast, deemed plaintiff to have connected the alleged deficiencies to the plaintiff's investment and loss.[11]

Understanding the issue in *Woori* and *Dexia* to be about the sufficiency of the alleged nexus between the widespread fraud and the plaintiff's loss illustrates how the requirements of Rule 9(b) do not pose an obstacle to plaintiffs alleging a widespread fraud that is inconsistent with the purposes of the rule.

Rule 9(b) imposes a heightened pleading standard to ensure the filing of legitimate claims based on a diligent understanding of the facts.[12] Ordinary loss-causation principles that require a clear and proximate connection between alleged misconduct and damages are consistent with the traditional requirements of that rule. As then District Judge Gerard E. Lynch explained in *In re Salomon Analyst AT&T Litigation*, for Rule 9(b) purposes it is insufficient to allege "a general atmosphere of conflicts of interest and institutional pressure for optimism." If not, it "would throw open the floodgates to lawsuits regarding all opinions issued by [defendant] that later proved ill-advised, even in the absence of the particularized allegations of fraud."[13] In effect, the requirement ensures that the plaintiff has a legitimate complaint against the defendant it is suing and is not just one of countless undifferentiated individuals affected by the financial crisis.

The principles animating Rule 9(b) requirements are, if anything, amplified where a single ruling on a broadly alleged fraud may lead to copy-cat claims. Financial crises can cause hundreds of billions of dollars to evaporate overnight due to a messy confluence of factors. The U.S. Supreme Court recognized this recently in *Dura* and again in *Erica P. John Fund*.[14] The potential scope of liability and range of defendants is as broad as the markets themselves. There is also no shortage of public speculation and theories about who or what may be responsible.

The cases addressing Rule 9(b) in this context suggest that while particularly pleaded fraud claims will continue to survive pleading motions, the Rules are still not amenable to litigation from parties that claim only a generalized fraud that is coincident with a major financial disruption.

The evolving application of Rule 9(b) to require that plaintiffs make a particularized showing that broadly alleged misconduct particularly caused the claimed loss advances Rule 9(b)'s purpose of ensuring that a plaintiff has a specific and particularized grievance against the defendant. It is also consistent with traditional legal principles that frown upon the use of fraud claims as a post-hoc insurance policy when markets fall.

1. See, e.g., *Republic Bank & Trust Co. v. Bear Stearns & Co.*, 683 F.3d 239 (6th Cir. 2012); *In re Lehman Brothers Sec. & ERISA Litig.*, 2013 WL 3989066 (S.D.N.Y. July 31, 2013); *Dexia SA/NV v. Bear, Stearns & Co.*, 929 F. Supp. 2d 231 (S.D.N.Y. 2013); *Union Cent. Life Ins. v. Credit Suisse Sec. (USA)*, 2013 WL 1342529 (S.D.N.Y. March 29, 2013); *Woori Bank v. Citigroup*, 2013 WL 1235648 (S.D.N.Y. March 27, 2013); *Dodona I v. Goldman, Sachs & Co.*, 847 F. Supp. 2d 624 (S.D.N.Y. 2012); *In re Bear Stearns Mortg. Pass-Through Certificates Litig.*, 851 F. Supp. 2d 746 (S.D.N.Y. 2012); *Woori Bank v. RBS Sec.*, 910 F. Supp. 2d 697 (S.D.N.Y. 2012); *Landesbank Baden-Wurttemberg v. Goldman, Sachs & Co.*, 821 F. Supp. 2d 616 (S.D.N.Y 2011); *Footbridge v. Countrywide Home Loans*, 2010 WL 3790810 (S.D.N.Y. Sept. 28, 2010).

2. See *Cognex v. Microscan Sys.*, 2013 WL 6906221 (S.D.N.Y. Dec. 31, 2013) (Rakoff, J.) (quoting *Exergen v. Wal-Mart Stores*, 575 F.3d 1312, 1327 (Fed. Cir. 2009)).

3. 929 F. Supp. 2d 231 (S.D.N.Y. 2013).

4. 2013 WL 1235648 (S.D.N.Y. March 27, 2013).

5. *Dexia*, 929 F. Supp. 2d at 238.

6. *Woori*, 2013 WL 1235648 at *5.

7. Id. at *4.

8. Id.

9. Memorandum of Law in Support of Citigroup Defendants' Motion to Dismiss the Complaint at 1-2, *Woori Bank v. Citigroup*, 2013 WL 1235648 (S.D.N.Y. March 27, 2013) (No. 12 Civ. 3868).

10. See *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172 (2d Cir. 2005).

11. *Dexia*, 929 F. Supp. 2d at 238.

12. *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 326 (S.D.N.Y. 2003).

13. 350 F. Supp. 2d 455, 469-70 (S.D.N.Y. 2004).

14. *Dura Pharm. v. Broudo*, 544 U.S. 336, 345 (2005)("[P]rivate securities fraud actions … [are] available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause."); *Erica P. John Fund v. Halliburton Co.*, 131 S.Ct. 2179, 2186 (2011) ("[T]he drop [of a stock's price] could instead be the result of other intervening causes, such as 'changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events.'") (quoting *Dura*, 544 U.S. at 342-43).