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As Investor Suits Tick Up, Loss Causation May Be A Hard Sell

By **Dean Seal**

Law360 (May 4, 2020, 6:17 PM EDT) -- In the wake of the COVID-19 crisis and in line with industry expectations, the number of securities cases filed in March and the first half of April has actually increased from years prior, according to a recent report from Lex Machina. But a volatile market may make it harder to prove fraud.

Historical trends show that securities cases tend to surge around crises and stock market turbulence. In 2001, after the dot-com bubble burst, the total number of securities class actions filed in federal court more than doubled from the year before, while filings increased by 46% between 2006 and 2007 and another 26% in 2008 as the global financial crisis roiled markets.

An April 25 **analysis from Lex Machina** reported that securities filings in the first two weeks of April are up 74% from the same period in 2019, following a slight but notable bump of 7% for the month of March. Litigation funder Burford Capital forecast in an investor report last week that a pandemic-induced economic downturn portends a spike in litigation, and defendant-repping law firms are imploring clients to mind their disclosures and mitigate risks.

But investors suspecting fraud may face a major hurdle — most securities fraud claims are filed under Section 10b-5 of the Securities Exchange Act of 1934, which requires plaintiffs to prove that a company's fraud, when revealed to the market, caused the price of its stock to drop. That can be tricky when stocks marketwide all fall at once.

"This is usually an expert issue that comes deep into the case — trying to parse out what actually caused the decline in a stock price on the dates in question," Jed Schwartz, a partner in Milbank LLP's litigation and arbitration group, told Law360. "And when you have a whole bunch of other stuff that's going on — the markets are going crazy, oil prices are volatile, the country's in a pandemic and who knows what else — it's very hard to answer that question."

The parameters for proving "loss causation" in securities fraud cases were tightened 15 years ago. In 2005, the U.S. Supreme Court ruled in Dura Pharmaceuticals v. Broudo et al. that plaintiffs must show it was the revelation of a fraud that caused a company's stock to drop, reversing a Ninth Circuit holding that plaintiffs could satisfy the loss causation requirement merely by alleging they purchased securities at prices artificially inflated by the fraud.

Earlier that same year, the Second Circuit affirmed the dismissal of Lentell v. Merrill Lynch & Co. Inc. , a test case for a larger multidistrict litigation accusing Merrill Lynch of issuing rosy research reports for internet companies that it knew faced dire liquidity issues just before the dot-com bubble burst.

The appellate judges wrote in their order that "when 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, and a plaintiff's claim fails when it has not adequately pled facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening market events."

Investors ultimately settled the wider MDL against Merrill Lynch for $125 million rather than contend with the heightened loss causation standard established under Dura and Lentell that went on to tank the case of settlement opt-out investor Ronald Ventura, who was told by a New York federal judge in 2008 that he hadn't shown his losses were caused by Merrill Lynch's allegedly fraudulent research reports and not the "collapse of the internet sector as a whole."

So while the financial crisis of 2007 and 2008 predictably drove up the filing of securities class actions in those years, defendants in those cases could now turn to Dura and Lentell to argue that investor losses from an alleged fraud could not be distinguished from losses caused by the housing crisis and broader market downturn.

"Any time you have market volatility, whether it is tied to a specific event or not, the defendants have the argument that plaintiffs can't plead and prove their losses were caused by the specific misrepresentation as opposed to other market factors," said Skadden Arps Slate Meagher & Flom LLP partner Robert Fumerton, whose firm represented the defendants in Lentell.

Fumerton, who represented UBS in the first-ever residential mortgage-backed securities action brought by a trustee to go to trial, recalls his team having "high hopes" that courts would build on the Lentell and Dura decisions in adjudicating cases that arose from the financial crisis.

He found the judiciary was generally reluctant to grant motions to dismiss on loss causation grounds in those cases, wanting at that stage to "disentangle losses that may have been caused by the revelation of the misstatement as opposed to the unprecedented collapse in the housing market," but it's a defense that can be deployed again at the summary judgment phase, Fumerton said.

"We'll certainly be making many similar arguments in litigation arising out of the COVID-19 crisis," Fumerton told Law360. "I think it should be difficult for plaintiffs to plead and prove that losses were caused by underwriting defects or other misrepresentations as opposed to a worldwide pandemic."

This defense against securities claims during market turmoil might not dampen the number of securities class actions filed, but it does lead to fewer successful cases and lower settlements, according to Jill Fisch, a professor of business law and co-director of the Institute for Law and Economics at the University of Pennsylvania Law School. That was the case 10 years ago, and the defense may again help insulate companies from securities fraud claims following the coronavirus pandemic.

"To the extent that there are fewer cases, or fewer are successful, or the size of recoverable damages is less, any of those things reduces the deterrent effect of securities fraud litigation," Fisch told Law360. "It either reduces the likelihood or the size of any potential penalty."

That said, investors are not without recourse; there are tools for factoring out the effect of general market movements from the effects of alleged fraud. While there may be more volatility during a global crisis, companies revealing corrective disclosures will see their stocks continuing to move downward "net of market- or industry-related volatility," according to Bernstein Litowitz Berger & Grossmann LLP partner Salvatore Graziano.

"We saw this in the 2008 crisis on a company-by-company basis where we had no issue demonstrating loss causation," Graziano told Law360.

Graziano, who has recovered billions of dollars for investors throughout his career, seemed unfazed by the suggestion that the recent market volatility would be a hindrance to securities litigation going forward and confident that the latest crisis will reveal more fraud, "which becomes difficult to hide in a downward cycle."

"Bottom line, if you are committing fraud, you should be more worried now than ever," Graziano said. "There will be no place to hide in market volatility."

--Editing by Philip Shea and Jill Coffey.

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