Analysis&Perspective

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Subprime Securities Litigation: Three Threshold Legal Issues

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Subprime woes continue. Companies continue to announce losses or write-downs; lawsuits continue to follow. It is too early in these cases to predict winners and losers. It is not too soon, however, to analyze the complaints and describe some main litigation battlegrounds. These are initial fights that could do much to determine the size of the litigation wave. This article reviews three of those battlegrounds.[1]

The *first* issue is whether plaintiffs can properly plead (a) false statements (b) that were made with scienter. Pleading these two elements with the required particularity is the entrance requirement for big-ticket securities litigation. The *second* issue is whether plaintiffs can show loss causation. This requires a showing that a plaintiff invested and lost money because of a lie by the defendant, not because the plaintiff chose to risk money in subprime-related investments. The *third* issue is whether certain companies are proper defendants at all: whether a plaintiff can bring a securities claim against a party that did not make a statement to the public, but acted only in the background to allegedly aid and abet fraud. This question looms large in subprime litigation because the structure of subprime-related activity so often involves multiple actors—underwriters, lenders, insurers, and servicers—who were not party to the transaction with the ultimate investor.[2]

In the last three years, courts have issued rulings that raise the hurdles to bringing securities claims, forcing plaintiffs to work harder to bring these big-ticket lawsuits. These developments appear to reflect a larger trend for courts to act earlier in the litigation process to filter out speculative claims.[3]

History suggests that we should watch whether the latest crisis will cause courts—at least the lower courts—to tilt toward easier access.

Now, however, these recent rulings will be tested in the crisis atmosphere that surrounds subprime cases. Historically, crises have caused judges to ease access to the courts in an effort to assist parties who may have suffered losses. For example, in two recent litigation waves, those following the dot-com bust and the Enron-era fraud cases, some courts altered doctrines in the direction of aiding plaintiffs.[4] This history suggests that

[1] For an overview of subprime securities litigation and enforcement activity, see Stephen J. Crimmins, Andrew J. Morris, and Daniel T. Brown, *Subprime Mortgage Lending: Possible Securities Litigation Exposure*, 39 Sec. Reg. L. Rep. 1455 (2007).

[2] This article does not directly address complaints brought under ERISA (typically alleging that corporate fiduciaries breached their duties of diversification and prudence by investing retirement plan assets in the employer's stock and failing to inform plan participants of the risks), *see, e.g.*, complaint in *Gray v. Citigroup, Inc.*, No. 07 CIV 9790 (S.D.N.Y., filed Nov. 5, 2007), or consumer actions against lenders, *see, e.g.*, *In re Ameriquest Mortgage Co. Mortgage Lending Practices Litig.*, No. 05-CV-7097, 2007 WL 1202544 (N.D. Ill. Apr. 23, 2007). Nor does it address disputes among participants in the business of financing or structuring subprime loans or investments. An example of these claims is the lawsuit filed by the trustee for lender American Home Mortgage Investment Corporation (AHMIC) against Lehman Brothers, which had funded AHMIC's lending operation. *See Am. Home Mortgage Holdings v. Lehman Bros. Inc.*, No. 07-11047 (CSS) (Bankr. D. Del., filed Aug. 6, 2007).

[3] Other reflections of this trend include the post-*Daubert* stricter standards for expert witnesses, *see, e.g.*, *In re Williams Sec. Litig.*, 496 F. Supp. 2d 1195, 1245-51 (N.D. Okla. 2007) (rejecting proposed expert testimony on loss causation and other topics for reasons including unreliable methodology), and closer pre-certification scrutiny of proposed classes, *see, e.g.*, *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24, 45 (2d Cir. 2006); *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 366 (4th Cir. 2004).

[4] An example is the expansion of the definition of primary conduct in the Enron litigation. *See In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 585-91 (S.D. Tex. 2002). The crisis atmosphere following Enron even led to calls to cut back some of the provisions of the Private Securities Litigation Reform Act (''PSLRA'') and to pass legislation reversing the Supreme Court's 1994 holding that the securities laws do not reach actors who only aid and abet violations. *See* discussions of these arguments in Douglas C. Conroy, et al., *In re Enron Sec. Litig.: Central Bank Encounters the 'Perfect Storm,'*

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we should watch whether the latest crisis will cause courts—at least the lower courts—to tilt toward easier access to large-scale litigation, or whether recent Supreme Court decisions will have their full effect and shut out more of those claims at the outset.

Size of the Litigation Wave—Three Issues

Federal securities claims are attractive to plaintiffs because they permit massive class actions where it otherwise would not be possible to aggregate numerous claims into a single case. However, precisely because securities class actions are so inviting to plaintiffs' counsel, the law imposes some special constraints on these cases. This article discusses some of those constraints and, based on review of subprime complaints filed to date, discusses how these constraints might affect subprime litigation.

Because most subprime complaints are still freshly filed, however, they may not provide a fully accurate picture of the plaintiffs' best cases. In large securities-fraud actions, plaintiffs often hurry to the courthouse with allegations that are quite general. Frequently, plaintiffs' counsel does not intend to defend the initial complaint on a motion to dismiss. Instead, counsel plans to use the delays caused by the requirement to publish a notice of the case, and by the process of selecting a lead plaintiff, to gather additional information.[5] Counsel then can use this information to file an amended complaint that contains more specific allegations. Because of this two-step pleading process, the initial complaints do not always indicate whether plaintiffs can meet the heightened pleading standards discussed below.

1. The Price of Admission: Pleading a False Statement and Scienter.

a. Pleading false statements in subprime cases. A securities-fraud plaintiff must establish, among other things, that ''the defendant made a false statement or omission of material fact.''[6] At the complaint stage, a plaintiff must describe a false statement in sufficient detail to satisfy the heightened pleading requirements that govern securities-fraud claims. These requirements are found in the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act, or ''PSLRA.'' Federal Rule of Civil Procedure 9 requires that plaintiffs plead all claims of fraud with ''particularity.'' The PSLRA imposes a still-stricter standard in securities-fraud cases. (Congress enacted the PSLRA in 1995 after it concluded that Rule 9's heightened requirement was not enough to discourage massive securities strike suits.[7]) With respect to alleged misstatements, the PSLRA requires that a complaint ''specify each statement alleged to have been misleading, and the reason or reasons why the statement is misleading.''[8]

In a subprime case, the plaintiff generally alleges that the defendant made misleading statements about the risk level of a specific security or of a company's activities. Typically, the complaint alleges that the defendant failed to disclose any connection with subprime mortgages or understated the level of the company's involvement with these mortgages, for example understating the extent of the company's investment in securitized subprime mortgages. The following are some examples.

- Investors in bond funds brought securities claims against the funds' manager and adviser (and others).[9] The complaint challenges representations that the funds offered ''higher yields without higher credit risk'' and ''broad diversification.''[10] In fact, the complaint alleges, the funds invested heavily in collateralized debt obligations (''CDOs'') and failed to disclose that they were ''far more vulnerable than other intermediate bond funds'' to a drop in subprime markets.[11] According to the complaint, the defendants misstated ''the nature of the risk being assumed by an investment in the Funds'', and failed to disclose the ''illiquidity of certain securities in which the Funds invested,'' and ''the concentration of investments in a single industry.''[12]

- In a complaint against Citigroup, Inc. brought by purchasers of its common stock, plaintiffs quote pages of Citigroup 2006 and 2007 disclosures about earnings and related operating results from various banking activities.[13] The plaintiffs allege that these disclosures were false in light of Citigroup's October and November 2007 writedown of certain CDOs.[14] According to the complaint, the earlier disclosures ''concealed the Company's failure to write down impaired securities containing subprime debt.''[15] This allegedly included the facts that Citigroup's ''portfolio of CDOs contained billions of dollars worth of impaired and risky securities, many of which were backed by subprime mortgage loans,'' and ''failed to record impairment of debt securities which they knew or disregarded were impaired.''[16]

- In a complaint against Merrill Lynch brought by purchasers of its common stock, plaintiffs allege that Merrill Lynch failed to disclose its exposure to CDOs that depend on subprime debt. The complaint does not identify specific statements that it contends were false, but quotes pages of Merrill Lynch disclosures and alleges that they were false by omission. According to the complaint, ''[t]he Company was more exposed to CDOs containing subprime debt than it disclosed,'' and ''[t]he Company's Class Period statements were materially false due to their failure to inform the market of the ticking time bomb in the Company's CDO portfolio due to the deteriorating subprime mortgage market which

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35 Sec. Reg. & L. Rep. 746 (2003), and Steven M. Schatz, *Ending Enrons?*, Legal Times, Feb. 18, 2002, at 38.

[5] 15 U.S.C. § 78u-4(a)(3).

[6] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. Rule 10b-5 provides that it is unlawful ''[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.'' *Id.*

[7] *See* discussion in *Calpers v. WorldCom, Inc.*, 368 F.3d 86, 98 (2d Cir. 2004), *cert. denied*, 543 U.S. 1080 (2005).

[8] 15 U.S.C. § 78u-4(b)(1)(B).

[9] Compl. in *Atkinson v. Morgan Asset Mgmt. Inc.*, (W.D. Tenn., filed Dec. 6, 2007) (asserting claims under sections 11, 12 and 15 of the Securities Act and section 34b of the Investment Company Act), ¶ 46.

[10] *Id.*

[11] *Id.* ¶ ¶ 38-42.

[12] *Id.* ¶ ¶ 1, 117-29.

[13] Compl. in *Saltzman v. Citigroup,* No. 07 CIV 9901 (S.D.N.Y., filed Nov. 8, 2007), ¶¶ 27-42.

[14] *Id.* ¶¶ 42-43.

[15] *Id.* ¶ 3; *see also id.* ¶¶ 47, 53.

[16] *Id.* ¶ 8.

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caused Merrill's portfolio to be impaired.''[17] Plaintiffs contend that Merrill Lynch's statements were proved false when the company announced an $8 billion write-down of its subprime mortgage and CDO portfolios.[18]

Defendants likely will make a number of arguments in their efforts to show that allegations like these fail to specify ''each statement alleged to have been misleading'' as well as ''the reason or reasons why the statement was misleading.''[19] Defendants will contend that the statements at issue are not false in the first place, because, read properly, they do not represent that the investment at issue was low-risk. Each defendant also will put the quotes selected by the plaintiff back in the context of the defendant's other disclosures, and point out that courts have dismissed complaints where a defendant's disclosures, read as a whole, identified the risks at issue.[20] Defendants also may contrast their disclosures with industry language that describes indisputably low-risk investments. They also might argue that some of the challenged statements are forward-looking statements protected by the safe harbor.[21]

In addition, defendants will fight plaintiff assertions that a substantial write-down can support an inference that the defendant should have taken the write-down earlier. The shareholder complaint against Merrill Lynch quoted above also illustrates this kind of allegation.[22] Faced with this kind of complaint, a typical defendant would contend that it took the charge at issue as soon as a decline in the value of the relevant asset became apparent—a routine accounting event that does not suggest an earlier misstatement. Courts sometimes dismiss complaints on this ground.[23]

b. Pleading scienter in subprime cases. A securities-fraud plaintiff also must establish that the defendant acted with ''scienter,'' a word that most courts interpret to mean ''recklessly or knowingly.''[24] To plead scienter, plaintiffs must satisfy the particularity requirement of Federal Rule of Civil Procedure 9(b), as well as the PSLRA's requirement that securities-fraud plaintiffs plead ''facts'' supporting a ''strong inference'' of scienter.[25]

Some complaints invite loss-causation challenges because of the timing of the drop in price.

Parties have disputed the meaning of this ''strong inference'' requirement since Congress enacted the PSLRA in 1995. The Supreme Court finally took up the question earlier this year. In *Tellabs v. Makor*, the Court held that, to satisfy this requirement, a plaintiff must plead ''facts'' showing that the plaintiff's inference of wrongdoing is ''more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference.''[26] Among the reasons the Court gave for its decision was concern about ''frivolous, lawyer-driven litigation.''[27] *Tellabs* followed on the heels of another Supreme Court decision that tightened the pleading standard for all complaints.[28]

Tellabs confirms that the PSLRA raised the hurdle for pleading scienter.[29] The decision's practical effect, however, will become clear only as lower courts apply it to specific complaints. Subprime litigation will provide an important round of test cases.

[17] Compl. in *Life Enrichment Found. v. Merrill Lynch & Co.*, No. 07 CIV 9633 (S.D.N.Y., filed Oct. 30, 2007) (''*Merrill Lynch* Compl.''), ¶ 38.

[18] *Id.* ¶ 6. The press release announced that ''Third-quarter write-downs of $7.9 billion across CDOs and U.S. subprime mortgages are significantly greater than the incremental $4.5 billion write-downs Merrill Lynch disclosed at the time of its earnings pre-release. This is due to additional analysis and price verification completed as part of the quarter-end closing process.'' *Id.*

[19] The parties will evaluate these disclosures against the understanding of the ''reasonable investor.'' *See, e.g.*, *In re Time Warner Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993) (stating that the meaning of statements and disclosures are construed through the lens of the ''reasonable investor''). *See also TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (holding that the standard for materiality is whether ''there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'')

[20] *See Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 5 (2d Cir. 1996) (stating that ''the 'central issue . . . is not whether the particular statements, taken separately, were literally true, but whether defendants' representations, taken together and in context, would have misl[ed] a reasonable investor about the nature of the [securities]' '') (quoting *McMahan & Co. v. Wherehouse Entm't, Inc.*, 900 F.2d 576, 579 (2d Cir.1990), *cert. denied*, 501 U.S. 1249 (1991)).

[21] 15 U.S.C. § 78u-5(c).

[22] *Merrill Lynch* Compl., ¶¶ 10, 34, 35, 38.

[23] *See, e.g., In re K-Tel Int'l, Inc. Sec. Litig*, 300 F.3d 881, 893 (8th Cir. 2002) (allegation that defendant should have made different estimates for contingencies did not suffice because ''the complaint [did] not explain what specific information was available and how any loss could be reasonably estimated'').

[24] *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2507 n.3 (2007) (stating that ''[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required'').

[25] Fed. R. Civ. P. 9(b); 15 U.S.C. § 78u-4(b)(2).

[26] *Tellabs*, 127 S. Ct. at 2505. In *Tellabs*, Mayer Brown LLP filed an amicus brief on behalf of the Securities Industry and Financial Markets Association and the Chamber of Commerce of the United States of America.

[27] *Id.* at 2509 (noting its concern about lawyer-driven litigation); *see also Bell Atl. Corp. v. Twombly*, 127 S. Ct. 1955, 1967 (2007) (linking its ruling to Judge Easterbrook's article, *Discovery as Abuse*, 69 B.U. L. Rev. 635, 638 (1989) (''Judges can do little about impositional discovery when parties control the legal claims to be presented and conduct the discovery themselves'')).

[28] Under long-standing rules of pleading, a plaintiff could begin a lawsuit, demand massive discovery, and often reach a jury, before a judge took a hard look at the complaint. *See Conley v. Gibson,* 355 U.S. 41, 45-46 (1957) (''a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief''). In 2007, the Supreme Court tightened this standard. In *Twombly*, 127 S. Ct. 1955, the Court ''retired'' the forgiving *Conley v. Gibson* standard and held that, to survive, a complaint must state enough ''facts'' to show that the claim is ''plausible on its face,'' and ''raise[d] a reasonable expectation that discovery will reveal evidence'' supporting the claim. Mayer Brown LLP was co-counsel for the petitioner. *Id.* at 1959, 60.

[29] For a concise account of *Tellabs* and its implications, see Steven Wolowitz & Joseph de Simone, *Did 'Tellabs' Raise PSLRA Scienter Bar?,* N.Y.L.J., Dec. 3, 2007, at S3.

Here are some examples of efforts to plead scienter in recently filed subprime complaints:

- In the shareholder complaint against Merrill Lynch that was noted above, plaintiffs alleged ''that top management of Merrill had been aware of the risk but concealed it and continued to make investments in CDOs due to the lucrative fees involved.''[30] The complaint relies heavily on a *Wall Street Journal* article published five days before the complaint was filed, which describes the Merrill Lynch announcement that it was taking an $8.4 billion write-down relating to subprime investments.[31]

- The same complaint alleges that ''Merrill's top officers knew it had problems with CDOs in its portfolio.''[32] It bases this allegation on the same *Wall Street Journal* report that a former Merrill Lynch senior employee had ''remarked'' that ''Merrill was doing business with [that is, purchasing CDOs from] too many unknown upstarts.''[33] This complaint also relies heavily on the amount of compensation paid to its senior officers, as evidence of a ''motiv[e]'' to commit fraud.[34]

- In a complaint filed by purchasers of Citigroup stock, plaintiffs base their scienter allegations largely on quotes from analyst reports. The complaint characterizes the reports as ''question[ing] the previous disclosures by the Company.''[35] For example, the complaint quotes an analyst comment that ''[t]he majority of the exposure against which Citi is taking a charge has never been disclosed before . . . which is very surprising.''[36] This complaint also alleges that the defendants' high compensation motivated them to commit fraud.[37]

- Often, plaintiffs will allege that stock sales by the senior officers who are individually named as defendants support an inference of scienter. Drawing from reports required to be filed with the SEC, plaintiffs identify stock sales that occur during the time of the alleged public misstatements. They then allege that the individual defendants' knowledge of the true facts of the financial condition of the company along with their participation in the dissemination of the allegedly misleading statements creates the strong inference of scienter.[38]

Subprime plaintiffs also have made scienter allegations based on information obtained from so-called ''confidential witnesses''—current or former employees of the defendant who make claims about wrongdoing inside the company. For example, a complaint against a loan originator alleges that ''management was consistently giving the green light on loans that [confidential witness] would not have closed.''[39] Defendants facing confidential-witness allegations will point to recent federal court of appeals decisions to argue that such allegations fail to meet the requirements of the PSLRA as clarified by *Tellabs*. So far, following *Tellabs*, both the Seventh and the Fifth Circuits have held that confidential-witness allegations should be viewed with strong skepticism.[40]

Defendants will contend that many of the scienter allegations in subprime complaints do not meet the *Tellabs* standard. It remains to be seen whether the sheer complexity of some of the disclosures at issue, the sheer length of some of the complaints, or possibly the sheer size of the claimed investor losses makes judges hesitant to dismiss complaints for failure to meet the newly tightened pleading standards.[41] The Supreme Court has, however, made it clear—in *Tellabs* and *Dura* as well as in *Merrill Lynch v. Dabit* and *Credit Suisse v. Billing*—that it will not have much tolerance for overly expansive views of the role of securities-fraud actions.[42]

2. Determining Whether a Plaintiff Lost Money Due to Fraud: Loss Causation.

a. The Supreme Court emphasizes the importance of loss causation. Loss causation requires a plaintiff to show a causal, economic connection between the plaintiff's loss and the defendant's wrongful conduct.[43] This

[30] *Merrill Lynch* Compl. ¶ 39.

[31] *Id.* ¶ 40. Other complaints construe references to hedging strategies as statements that investments were less risky than subprime investments. *See, e.g.*, Compl. in *Reese v. Indymac Fin., Inc.*, No. CV-07-1635 (C.D. Cal. filed Mar. 12, 2007), ¶ ¶ 72, 90, 111, 113, 131 (''*Indymac* Compl.''); *Greenberg v. Luminent Mortgage Capital, Inc.*, No. C 07 4141 (N.D. Cal., filed Aug. 13, 2007), Compl. ¶¶ 8, 23, 27; *Marlin v. Citigroup Global Mkts., Inc.*, No. CV 07-3580 (E.D.N.Y., filed Aug. 27, 2007), Compl. ¶ 33.

[32] *Merrill Lynch* Compl. ¶¶ 25-26.

[33] *Id.*

[34] *Id.* ¶ 23. *See also id.* ¶ 39. The Second Circuit, for example, has held that allegations of scienter allegedly supported by ''the desire to maintain or increase executive compensation is insufficient because such a desire can be imputed to all corporate officers.'' *Kalnit v. Eichler*, 264 F.3d 131, 139-40 (2d Cir. 2001). *See also In re LaBranche Sec. Lit.*, 405 F. Supp. 2d 333, 353-54 (S.D.N.Y. 2005) (executive compensation packages in the tens of millions of dollars insufficient to support an inference of scienter).

[35] *Saltzman* Compl. ¶ 49; *see also id.* ¶ 47.

[36] *Id.* ¶ 49.

[37] *Id.* ¶¶ 24-25.

[38] *E.g.*, *Ferenc v. E*TRADE Fin. Corp.*, No. 07 CV 10540 (S.D.N.Y., filed Nov. 21, 2007).

[39] *Indymac* Compl. ¶ 59.

[40] *See Higginbotham v. Baxter Int'l Inc.*, 495 F.3d 753 (7th Cir. 2007); *Cent. Laborers' Pension Fund v. Integrated Elec. Servs., Inc.*, No. 06-20135 (5th Cir., filed Aug. 21, 2007).

[41] Plaintiffs might try to circumvent the requirement for pleading with specificity by filing securities claims that are not fraud claims. See, e.g., *Marlin v. Citigroup Global Mkts., Inc.*, No. CV 07-3580 (E.D.N.Y., filed Aug. 27, 2007) (asserting claims under sections 11, 12 and 15 of the Securities Act). This does not always work, as a number of courts have held that Section 11 claims sound in fraud and therefore must be pleaded with specificity. *See, e.g., Wagner v. First Horizon Pharm. Corp.*, 464 F.3d 1273 (11th Cir. 2006) (finding that heightened pleading standard applied to claims brought under Section 11 of the Securities Act when the claims sound in fraud); *Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004) (same); *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399 (9th Cir. 1996) (same).

[42] *See Credit Suisse Sec. (USA) LLC v. Billing*, 127 S.Ct. 2383 (2007) (holding that Congress's creation of the SEC implicitly exempted the regulated securities industry from certain antitrust lawsuits); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006) (holding that state-law ''holder'' claims are preempted by the Securities Litigation Uniform Standards Act of 1998). Mayer Brown was counsel of record for the petitioner in *Billing* and filed an amicus brief for the U.S. Chamber of Commerce in *Dabit*.

[43] *See In re Salomon Smith Barney Mut. Funds Fees Litig.*, 441 F. Supp. 2d 579, 588 (S.D.N.Y. 2006) (''Loss causation is the causal link between the alleged misconduct and the eco-

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connection must have two parts. The first is price inflation: that the plaintiff overpaid for the security because of the defendant's misstatement. The second is a causal link to the price drop: that the security lost value at the time the market learned the truth. These requirements ensure that the security did not lose value simply because the entire market fell or the issuing company suffered setbacks, but lost value because the specific misstatement at issue was exposed.[44]

Two years ago, the Supreme Court issued a decision that stressed the importance of the loss-causation requirement in securities cases. In *Dura Pharmaceuticals v. Broudo*, the Court explained that it is not enough for a plaintiff to show that a misstatement caused the security to be overpriced; a plaintiff also must establish the second component of loss causation by identifying a disclosure of the ''relevant truth'' at the time of the decline in price.[45]

The typical complaint's theory is that, had plaintiffs known that their investment depended on subprime loans, they would have invested in different, higher-grade investments.

The Court also expressed its concern about unwarranted securities litigation. It cautioned that the securities laws were not intended as an investment insurance scheme, but rather ''to protect [investors] against those economic losses that misrepresentations actually cause.''[46] The Court noted that the existing loss causation rule is part of a statutory scheme—the PSLRA—that was designed to weed out frivolous suits while ''permit[ting] private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss.''[47]

The Supreme Court did not, however, precisely articulate the pleading requirement for loss-causation.[48] That question has been playing out in the lower courts, and should be a central issue in subprime cases.

b. Implications for subprime cases. Subprime securities actions add an interesting twist to loss-causation disputes. As explained in the above discussion of the ''false statement'' requirement, the heart of a typical subprime complaint is the allegation that the defendant did not properly disclose that the value of the relevant security was affected by the performance of subprime mortgages. From this starting point, the typical complaint contends that, when the subprime market declined, the defendant company disclosed that its value, or that of the company's underlying investments, had declined. This disclosure was, according to the complaint, the first time the market learned the extent of the defendant company's vulnerability to changes in the value of (or investment) was dependent on subprime loans.[49] The typical complaint's theory is that, had plaintiffs known that their investment depended on subprime loans, they would have invested in different, higher-grade investments.

Under this theory, the alleged inflation in the value of the security is due to the market's erroneous belief that the value of the security did not depend on subprime loans. The inflation comes out of the security's price when the defendant makes a disclosure that reveals the connection to subprime mortgages.

To establish price inflation in a subprime case, a plaintiff might try to show that the security's price was inflated in comparison with a security that the market knew was tied to subprime risks. To make this showing, a plaintiff might contrast the security's actual price with some benchmark: with the price of a security that matches the true, higher risk level allegedly hidden by the disclosures.[50] By comparing the actual price of the defendant's security to a valid benchmark, the plaintiff might identify the amount of any artificial price inflation.[51]

To satisfy the corrective-disclosure requirement, a subprime plaintiff must identify a public statement revealing the truth: that the security was, in fact, dependent on subprime mortgages. A review of subprime complaints suggests that defendants will dispute whether plaintiffs have pleaded this kind of corrective disclosure. For example, in *Greenberg v. Luminent*, the alleged misstatement was an overstatement of the quality of this REIT's investments.[52] The alleged corrective disclosure was a statement that conditions in ''the mortgage industry'' had worsened so that Luminent suffered certain negative effects.[53] It is not clear how this establishes the required ''relevant truth.''

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nomic harm ultimately suffered by the plaintiff.''). Loss causation is an element of section 10(b) claims under the Exchange Act. 15 U.S.C. § 78u-4(b)(4) (''In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.''); *see also id.* (''Loss causation is an element in Plaintiffs' Section 10(b) claim under the Exchange Act.'') (citation omitted). It is also an affirmative defense to claims under sections 11 and 12 of the Securities Act of 1933. 15 U.S.C. § 77k(e); 15 U.S.C. § 77*l*(b).

[44] The loss-causation requirement is not unique to securities-fraud cases, but is an application of the common-law concept of proximate cause. *See* discussion in Andrew J. Morris & Lucius Outlaw, *Clarifying Loss Causation: Reconciling the ''Zone of Risk'' Test with Dura Pharmaceuticals*, 38 Sec. Reg. & L. Rep. 1910, 1911. Courts have, however, refined the concept in the context of securities fraud. *Id.* at 1912-13.

[45] 544 U.S. 336 (2005). Mayer Brown LLP filed an *amicus curiae* brief in *Dura* on behalf of Merrill Lynch.

[46] *Id.* at 345.

[47] *Id.* at 346.

[48] On pleading requirements after *Dura*, *see* Steven R. Paradise & Ari M. Berman, *Pleading the Loss Causation Link*, N.Y.L.J., Dec. 3, 2007, at S4. *See also* Brief for the United States as Amicus Curiae, *Dura Pharmaceuticals*, 544 U.S. 336 (2005) (contending that the particularity requirement of Rule 9(b) governs the pleading of loss causation).

[49] *Merrill Lynch*, No. 07 CIV 9633 (S.D.N.Y.).

[50] For examples of this benchmark approach, *see Atkinson v. Morgan Asset Mgmt.* Compl. ¶¶ 48-55; *Prudential* Compl. ¶¶ 23, 27.

[51] Plaintiffs will want to use comparables that reflect investments with significantly lower levels of risk, possibly triggering *Daubert* battles about plaintiffs' proposed expert testimony.

[52] *Greenberg* Compl. ¶¶ 34-36.

[53] *Id.* ¶ 34.

In some cases, such as actions against investment banks, subprime plaintiffs may refer to benchmarks identified in the defendant's disclosures. Plaintiff may argue that, to the extent that a fund's value fell more than the relevant benchmark, the cause must be due to misstatement of the fund's investments. For example, one recently filed complaint alleged that the managers of an investment fund ''radically altered'' their stated investment strategies without advising investors.[54] The plaintiff contends that ''[a]lthough both funds were supposed to closely track benchmark indexes, with a 'maximum' annual difference from the benchmark of 0.75%, in just two months the Bond Funds fell short of their respective benchmarks by approximately 28% and 14%.''[55]

Regardless of the outcome of *Stoneridge*, plaintiffs still will have possible alternate routes to secondary actors.

Some complaints invite loss-causation challenges because of the timing of the drop in price. An example is the above shareholder class action against Merrill Lynch. In that case, most of the price decline *preceded* the announcement that the company would take a larger write-down in losses than predicted. [56]

The loss-causation requirement can be a powerful tool for sorting out cases filed in the wake of a market-wide event.[57] It will be interesting to see, however, how many subprime cases the post-*Dura* loss-causation requirement brings to an end.

[54] *Prudential* Compl. ¶ 3.

[55] *Id.*

[56] A decline of more than $16 between July 2, 2007 and Oct. 23, 2007 preceded the Oct. 24, 2007 announcement. Daily trading prices for Merrill Lynch common stock available at *http://www.bloomberg.com*.

[57] It has long been recognized that loss causation is a basic element of a viable securities fraud claim. The Private Securities Litigation Reform Act of 1995 codified this requirement, stating that ''[i]n any private action arising under [the Exchange Act], the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.'' 15 U.S.C. § 78u-4(b)(4).

Note to Readers

The editors of BNA's *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

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3. Determining How Many Defendants a Plaintiff Can Reach: "Scheme" Liability.

Secondary Actors. Another major battleground is the extent to which securities purchasers can reach beyond the company that issued the securities and made statements to the market—the ''primary'' actor—and sue players who helped create the securities and bring them to market, but remained in the background. These other players—underwriters, accountants, lawyers, and bankers—are the ''secondary actors'' in these transactions. Plaintiff efforts to reach secondary actors have generated decades of litigation.

The Supreme Court appeared to close the door to most securities claims against secondary actors in its 1994 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[58] There, the Court held that private plaintiffs cannot bring ''aiding-and-abetting'' claims under the federal securities laws. This appeared to prevent most plaintiffs from bringing claims against secondary actors. In 1995, when Congress passed the PSLRA, it rejected pleas to reinstate private liability for secondary actors.[59]

But plaintiffs have not given up. Since *Central Bank*, they have tried to reach secondary actors using a different theory: that those defendants were not merely ''aiders and abettors,'' but were instead primary actors in ''schemes'' to defraud the plaintiffs.[60] In response, the defense bar has argued that this ''scheme liability'' theory is nothing more than the aiding-and-abetting liability ruled out by *Central Bank*.[61]

The lower courts have split over the viability of scheme liability.[62] The question reached the Supreme Court in October 2007, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[63] The Court's decision is pending.[64]

The stakes are high for potential subprime plaintiffs and defendants. Numerous participants usually are involved in bringing mortgage-backed securities or CDOs to market. A viable ''scheme liability'' theory could enable investors to sue these various participants, even if they would otherwise be viewed as secondary actors. Whether these participants are subject to ''scheme liability'' may determine whether injured plaintiffs may recover when, for example, the only primary actor is a trust that lacks assets sufficient to satisfy a judgment.

[58] 511 U.S. 164 (1994).

[59] *Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud: Hearing before the Subcomm. on Sec. of the Sen. Comm. on Banking, Hous., & Urban Affairs*, 103d Cong. 82, 83 (1994).

[60] Br. for Petitioner at 15, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*(No. 06-43).

[61] *Id.*, Br. for Respondents at 12, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.* (No. 06-43).

[62] *Compare Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006) *with Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007).

[63] 128 S. Ct. 35 (2007). In *Stoneridge* itself, investors in a bankrupt cable company seek to recover their losses from two suppliers who made sales to the cable company that the cable company then allegedly misreported in a way that inflated its own revenue. The plaintiffs say that the suppliers should be held liable for involvement in the scheme; the suppliers respond that they did not deceive the market and made no determinations regarding how Charter accounted for the transactions.

[64] Mayer Brown LLP is counsel of record for the petitioner.

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The Supreme Court's resolution of *Stoneridge* could have a significant effect on the size of the subprime litigation wave.

Regardless of the outcome of *Stoneridge*, plaintiffs still will have possible alternate routes to secondary actors. Each route, however, has its own limitations. For example, state law frequently permits aiding-and-abetting liability in fraud cases,[65] but this option is limited by Securities Litigation Uniform Standards Act, or SLUSA, which precludes most securities related class actions from being brought in state court.[66] Some plaintiffs might have standing to bring non-fraud actions such as negligent misrepresentation, third-party beneficiary, and even fiduciary claims.[67] It generally is difficult to bring these state-law claims as class actions, however, because state laws generally do not permit plaintiffs to establish reliance through the fraud-on-the-market theory.

Also regardless of the outcome of *Stoneridge*, the Securities and Exchange Commission will retain its existing authority to bring enforcement actions for aiding-and-abetting violations of Rule 10b-5 under the Securities Exchange Act.[68] Whatever the outcome of *Stoneridge*, it is likely that the government will continue to examine the activities of all of the participants in the subprime arena.[69]

Conclusion. During 2008, we will see the extent to which the recent tightening of the requirements for big-ticket securities cases will weed out subprime-related claims. Once the Supreme Court decides *Stoneridge*, we also will see how plaintiffs attempt to reach upstream and downstream participants in the subprime securitization chain. Decisions issued in the next year will, therefore, determine the size of the subprime wave and, at the same time, tell us much about the full impact of recent Supreme Court decisions.

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[65] Thus, in *Miller v. Santilli* (American Business Financial Services, Inc.), No. 06-3587, 2007 WL 839981 (E.D. Pa. Mar. 15, 2007), aiding-and-abetting claims survived a motion to dismiss. Another example is in the Bear Stearns-related litigation, which asserts aiding-and-abetting claims against other entities.

[66] *See Dabit*, 547 U.S. 71 Mayer Brown filed an amicus brief for the United States Chamber of Commerce.

[67] *See, e.g., Bankers Life Ins. Co. v. Credit Suisse First Boston*, No. 8:07-cv-00690-EAK-MSS (M.D. Fla., amended complaint filed Aug. 27, 2007) (asserting negligent misrepresentation claim and third-party beneficiary claim).

[68] *See* Exchange Act § 20(e), 15 U.S.C. § 78t(e).

[69] The SEC formed a 25-member working group within the Enforcement Division to investigate possible fraud related to subprime mortgages. *See* discussion in Stephen J. Crimmins, 39 Sec. Reg. & L. Rep. 1455 (2007).