Coming to Terms with Loss Causation After *Dura*: A Response to Professors Partnoy, Ferrell, and Saha

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I. INTRODUCTION

At the 15th Institute for Law and Economic Policy (ILEP) conference in Scottsdale, Arizona, *Compensation of Plaintiffs in Mass Securities Litigation*, I had the privilege of sitting on a panel that presented papers by Frank Partnoy (Dura *Fraud*)[1] and Allen Ferrell and Atanu Saha (*Securities Litigation and the Housing Market Downturn*)[2]. From different perspectives, both papers try to come to terms with the aftershocks of the Supreme Court's loss causation holding in *Dura Pharmaceuticals, Inc. v. Broudo*.[3] The holding was unambiguous: "an inflated purchase price will not itself constitute or proximately cause the relevant economic loss" needed to demonstrate loss causation.[4] I contend that there is no basis for the lower federal courts to interpret *Dura* as creating a major roadblock in the ability of plaintiffs to demonstrate loss causation. From this perspective, I provide the following comments on each Article.

II. DURA *FRAUD* BY FRANK PARTNOY

Pleading loss causation requires demonstrating the existence of "a causal connection between the material misrepresentation and the loss."[5] However, as Professor Partnoy correctly points out, *Dura* has made it possible for corporate management to strategically disclose information that purposely obscures the causal connection.[6] He refers to this behavior as *Dura* fraud strategic behavior.[7] For example, in a strategy which Professor

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1. *See* Frank Partnoy, *Dura* Fraud (Apr. 24, 2009) (unpublished manuscript presented at the 15th Annual Institute for Law and Economic Policy Conference: Compensation of Plaintiffs in Mass Securities Litigation, on file with *The Journal of Corporation Law*).
2. Allen Ferrell & Atanu Saha, *Securities Litigation and the Housing Market Downturn*, 35 J. CORP. L. 97 (2009).
3. Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005).
4. *Id.* at 342.
5. *Id.*
6. Partnoy, *supra* note 1, at 1.
7. *Id.* at 4.

Partnoy refers to as "simultaneous disclosure," a company purposely releases material good news on the same day that it provides the market with a corrective disclosure regarding a concealed risk.[8] If the two news items cancel each other out, then there will be no effect on the stock price. But if there is no significant decline in the stock price from the disclosure of the fraud, then it is very difficult for plaintiffs to demonstrate that the material misrepresentation caused investors an economic loss. A different type of *Dura* fraud strategy is what Professor Partnoy calls "leakage."[9] This strategy relies on leaking information so that there is no obvious explanation for how the truth was revealed and how market participants acted on that information.[10]

To make matters worse, Professor Partnoy speculates that corporate management may have a fiduciary duty to the corporation to engage in such strategies in order to minimize potential litigation costs to the corporation.[11] This type of fiduciary duty is unacceptable, and I can only hope that the courts recognize this strategic behavior for what it is: a breach of management's duty of loyalty and good faith owed to their investors, both current and former. Professor Partnoy's novel solution to *Dura* fraud strategic behavior is to "expand the kinds of allegations that survive motions to dismiss based on loss causation at the pleading stage, depending on whether there are allegations suggesting that defendants engaged in [such behavior]."[12] The result is an exception to providing evidence of a large price drop when pleading loss causation.

I am sympathetic to Professor Partnoy's goal of minimizing the effects of *Dura* fraud behavior and thereby reducing the number of meritorious cases dismissed because of it. However, to do what he suggests requires a fact-specific inquiry based on a developed record. Under the Private Securities Litigation Reform Act of 1995 (PSLRA), all discovery is stayed until the pendency of a motion to dismiss.[13] Therefore, plaintiffs would have to rely on public information and insider witnesses willing to come forward in order to make non-spurious allegations of *Dura* fraud behavior. This may be a very difficult evidentiary hurdle to overcome. Moreover, I am not sure how receptive the courts would be to making securities class action litigation—already complex and document intensive—that much more complex when overseeing a motion to dismiss. However, if these issues can be overcome, I would welcome the enhanced ability to overcome *Dura* fraud behavior.

8. *Id.* at 2. Simultaneous disclosure could also include the purposeful disclosure of unrelated bad news in order to obscure how much of a decline in the security price is actually caused by the disclosure of the material misrepresentation. *Id.*

9. *Id.*

10. This strategy got a boost from the recent case of *In re Williams Securities Litigation*, where plaintiffs could not satisfactorily establish loss causation based on leakage. 558 F.3d 1130, 1143 (10th Cir. 2009).

11. Partnoy, *supra* note 1, at 3.

12. *Id.* at 1. Professor Partnoy further suggests that this type of behavior may be used to satisfy the pleading requirements of scienter. *Id.* at 4. However, this is a very difficult argument to make, as defendants are not acting recklessly or making false or misleading statements, but are simply trying to limit their liability.

13. 15 U.S.C. § 78u–4(b)(3)(B) (2006).

III. *Securities Litigation and the Housing Market Downturn* by Allen Ferrell and Atanu Saha

Dura did not answer the question of how to plead loss causation under section 10(b) of the Exchange Act; it only said that an inflated price alone would not suffice.[14] For that, we can look to the lower courts for guidance. In the Second Circuit, the requirements for pleading loss causation were established in *Lentell v. Merrill Lynch & Co.*,[15] a case that was decided four months prior to *Dura*. According to *Lentell*, establishing loss causation "require[s] both that the loss [to the investor] be *foreseeable and* that the loss be caused by the materialization of the concealed risk."[16]

Lentell is an excellent case for framing the work of Professors Ferrell and Saha, not only because the bulk of the securities fraud litigation associated with the recent financial crisis has been filed in the United States District Court for the Southern District of New York, but because Professors Ferrell and Saha believe the central issue for establishing liability in such litigation is one of foreseeability.[17] In the context of the financial crisis, they believe the issue is "the extent to which the downturn in the housing market, and the resulting financial institutional write downs and losses on securities with substantial real estate exposure" were foreseeable by defendants.[18]

As a proxy for defendant foreseeability, Ferrell and Saha argue that market foreseeability can be used.[19] Moreover, this time zone of foreseeability can be established empirically by analyzing what the markets were telling us about expected housing prices as we entered the financial crisis.[20] Once this time zone of foreseeability has been established, then it can be determined whether defendants' disclosures on the performance of their mortgage-related portfolios were adequate.[21]

I am not sufficiently versed in statistics to comment on whether or not their statistical analysis is correct. Then again, I am not sure if it really matters. It is always foreseeable that prices can go down, whether we are talking about the stock market or the housing market. Market expectations are based on a large number of participants with a wide range of expectations: some that believe prices will go up, others that believe they will go down. For example, if the market provides an unbiased estimate that housing prices will go up by three percent next year, there will still be a large number of market participants that believe prices will fall. Such analysis tells a court very little about the expectations of any particular defendant involved in securities litigation.

Moreover, I personally cannot see the relevance of determining when market housing prices were on the way down when working in a legal framework in which each case must be evaluated on its own merits. Most importantly, it is the facts and circumstances underlying each case that matter: what the defendants were saying versus what they were actually doing, and what they were aware of at a particular time. If the

14. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 346–47 (2005).
15. Lentell v. Merrill Lynch & Co., 396 F.3d 161 (2d Cir. 2005).
16. *Id.* at 173 (first emphasis added).
17. Ferrell & Saha, *supra* note 2, at 98.
18. *Id.*
19. *Id.*
20. *Id.* at 100-01.
21. *Id.* at 105.

issue is when the defendants knew that their company's portfolio of housing-related assets was falling in value, or was suffering tremendously because customers were defaulting on their loans, or that their underwriting standards were not being followed, then the time at which the defendants knew that to be the case is the relevant time, not the time when the markets first became aware on some macro level. Therefore, it is incorrect to take the approach that if it was not foreseeable for the markets, then it should not have been foreseeable by the defendants.

Also, by arguing that the increase in delinquencies and foreclosures followed primarily from declines in housing prices, as opposed to inadequate underwriting standards, Ferrell and Saha's approach minimizes the misrepresentation of underwriting standards as a concealed risk. Perhaps the misrepresentation of underwriting standards was not significant in one case, but it certainly could have been significant in another. Again, each institution in question had a unique portfolio of real-estate-related assets which required separate evaluation. Sweeping generalizations are insufficient for a proper determination of loss causation.