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SECURITIES CLASS ACTION LITIGATION

Collateralized Debt Obligations: Burden Is on Defendants

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The recent downturn in the market for mortgage-backed securities and collateralized debt obligations (CDOs) [FN1] has inflicted devastating losses on many investors. Among those hit hardest by the collapse are investors that purchased AAA-rated tranches of CDOs backed in whole or in part by risky subprime mortgage loans that were worth much less than their investment-grade ratings represented.

With delinquency and foreclosure rates on subprime mortgages reaching an all-time high last year, there are fears that many more of the underlying loans are likely to default. The result has been a plunge in the value of mortgage-backed securities and CDOs. In 2007 alone, financial companies had to write down over \$80 billion worldwide because of the decrease in the value of mortgage-backed securities. [FN2]

Parties That Played Role in Sale of CDOs

Faced with mounting losses, investors are increasingly pursuing litigation against parties that played a role in the issuance and sale of CDOs and made misrepresentations regarding their risk. Claims against entities involved in the securitization process will likely focus on misrepresentations regarding the quality of the assumptions used for defining the risk and reward of CDOs purchased by investors, as well as the quality of the underlying mortgage-backed securities.

In many cases, CDOs and mortgage-backed securities were overvalued and their risks were not sufficiently disclosed to investors. In fact, some of the companies that packaged mortgage-backed securities into CDOs, and others associated with their sale, did not disclose that a large number of the underlying mortgages were issued to some of the least credit-worthy borrowers and that appraisals of properties underlying the mortgages were often inflated, among other nondisclosures. As a result, the securities are no longer marketable at prices anywhere near the prices paid by investors because the securities lost, or will soon lose, their triple A credit rating. Yet, pricing information is generally not available for such securities and, as a result, investors in CDOs are less likely to be able to point to a price decline in response to a negative announcement should they file suit.

This price decline conundrum brings the issue of §11 of the Securities Act of 1933 (the Securities Act) and loss causation squarely into focus. Many CDO-type cases will be brought by investors who purchased CDOs pursuant to a registration statement, which incorporated a prospectus alleging violation of §11. Section 11 imposes strict liability on an issuer for making material misrepresentations or omissions in a registration statement. [FN3]

Under §11, a plaintiff is not required to plead or prove 'loss causation,' [FN4] i.e., that the economic loss, such as a decline in the value of a security, is caused by the alleged misrepresentation. Pursuant to the statutory language of §11, defendants bear the burden of proving that factors other than the alleged misrepresentations and omissions caused the decrease in value of the subject security. [FN5]

Defendants' burden to establish 'negative causation' is reserved for summary judgment and should not be decided on a motion to dismiss.

Recently, however, several courts have taken the unusual step of granting motions to dismiss §11 claims holding that defendants' affirmative defense was plain on the face of plaintiff's complaint.

In general, the courts in these cases looked at the alleged misrepresentation and/or omission and determined that the alleged price decline was not related thereto and granted defendants' motion to dismiss. Undoubtedly these decisions are influenced greatly by the U.S. Supreme Court's decision in [Dura Pharmaceuticals v. Broudo](#), [FN6] which held that a plaintiff is required to show a nexus between a plaintiff's economic injury and a defendant's material misrepresentation in connection with pleading a claim for violation of §10(b) of the Exchange Act. [FN7] Under these authorities, plaintiffs asserting §11 claims relating to their purchases of CDOs may face difficulties in the face of the inevitable motion to dismiss if they cannot point to a price decline in reaction to a negative announcement.

'Levine v. AtriCure'

The recent decision in *Levine v. AtriCure Inc.* reaffirms the proper analysis under the statutory language of §11 and debunks the holdings of the Dura - influenced courts. [FN8] Under *AtriCure*, plaintiffs in CDO cases will not have to allege a price decline in order to sufficiently state a claim under the Securities Act and the burden of proving that the plaintiff has not suffered a loss as a result of the alleged misrepresentation or omission will properly be shifted to the Defendants.

In *AtriCure*, the lead plaintiff in a class action purchased shares of AtriCure, a medical equipment company, shortly after the company's initial public offering (IPO) and sold the stock three months later for a loss, but before the disclosure of the facts allegedly omitted from the registration statement. [FN9] After the plaintiff sold his shares, the Wall Street Journal reported that a clinic, where procedures using AtriCure's equipment were being performed, was itself an investor in AtriCure and that the company had employed some of the doctors at the clinic as paid consultants. [FN10] Plaintiffs subsequently sued AtriCure and the underwriters of its IPO for a violation of §11 of the Securities Act for failure to disclose material facts in the registration statement and prospectus, i.e., its relationship with the clinic. [FN11]

Defendants moved to dismiss the complaint on the grounds that the lead plaintiff failed to allege loss causation. Specifically, defendants, relying on *Dura* and other cases, argued that by selling his AtriCure shares prior to the publication of the allegedly undisclosed facts, the lead plaintiff would be unable to allege or prove that he was injured by the nondisclosure. [FN12]

The court disagreed with defendants' argument, holding that the plaintiff had no obligation to plead or prove loss causation in a §11 case. [FN13] In dismissing defendants' loss causation argument and their reliance on *Dura*, the court explained that §11 cases are distinct from 10(b) cases because loss causation is not an element of a §11 claim. [FN14] Unlike, 10(b) claims, loss causation is presumed in §11 cases. [FN15] A plaintiff in a §11 case is only required to plead a material misstatement or omission in a registration statement and any subsequent decline in value of a security is presumed to be caused by the misrepresentation. [FN16]

The burden of disputing loss causation is on the defendants, in the form of an affirmative defense, which generally is only appropriate on a motion for summary judgment. [FN17] The allocation of burden to the defendants reflects congressional intent to shift the risk of uncertainty to the defendants. [FN18] The shift is driven by the fact that §11 is designed to deter negligence by making liable those who fail to investigate or verify information in a registration statements, rather than to compensate the defrauded investor for a loss caused by the

misrepresentation. [FN19] Shifting the burden of proof to defendants satisfies the intent of §11 by making it easier for a plaintiff to plead a claim.

#### 'Merrill Lynch Research'

Cases that have disposed of §11 claims on a motion to dismiss are distinguishable from AtriCure and do not contradict AtriCure's holding with respect to the burden of proof on loss causation in §11 cases. For example, in *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, an action that included claims under the Securities Act and the Exchange Act, the district court granted a motion to dismiss a §11 claim based on lack of loss causation because the negative causation defense was apparent from the face of the complaint. [FN20] There, the plaintiffs alleged that their losses stemmed from a decline in the value of the stock price. [FN21] Plaintiff's losses occurred before the first disclosure of information concerning certain investment banking conflicts that plaintiffs alleged should have been included in the registration statement and prospectus. [FN22] The court dismissed the complaint on multiple grounds. It found that the plaintiff 'failed to plead any material omissions that the defendants had a duty to disclose,' [FN23] and, following an intensive factual analysis, that defendants had indeed proved that plaintiff's shares declined in 'an amount proportional to the decline in the entire technology sector.' [FN24] In addition, as Judge Richard J. Holwell noted in the AtriCure decision, the court in *In re Merrill Lynch* 'cited no other cases in which a Rule 12(b)(6) motion to dismiss was granted based on the absence of loss causation in a Section 11 claim,' but only cited to cases 'either made on motions for summary judgment or after trial.' [FN25] While on a summary judgment motion or at trial, a plaintiff may present evidence that their loss resulted from the defendant's nondisclosure, a plaintiff does not have such an opportunity at the motion to dismiss stage. [FN26]

In *Davidco Investors, LLC v. Anchor Glass Container Corp.*, another action that included claims under the Securities Act and the Exchange Act, the court, dismissing plaintiffs' §11 claim, held that it was apparent from the face of the complaint that plaintiffs could not recover their alleged losses. [FN27] Specifically, the court found that defendants met their burden of proving negative causation by showing that plaintiffs' losses did not result from any alleged misstatements because plaintiffs sold all of their stock prior to a corrective disclosure by defendants. [FN28] However, the court acknowledged that plaintiffs 'have no obligation to plead loss causation as a part of their prima facie Section 11 claim' and that 'once a plaintiff has alleged that he purchased a security traceable to a registration statement containing material misrepresentations, any decline in value is presumed to have been caused by the misrepresentations in the registration statement.' [FN29] This case and others like it, [FN30] were distinguished in AtriCure as having 'failed to recognize the possibility that declines in stock price prior to broad public disclosure may be reflective of leaking of relevant information into the marketplace' and, consequently, 'improperly ignore[d] the presumption of causation.' [FN31]

#### Conclusion

The issue of loss causation and liability under the Securities Act is sure to come to the fore as CDO-related litigation winds its way through the courts. The well-reasoned decision in AtriCure properly and appropriately interprets §11 in line with Congress' intent in passing the law and places the burden of loss causation squarely on the defendants.

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FN1. CDOs are packages of debt such as asset-backed securities, or other investments, that are sold as bonds and are structured to pay out at different rates of interest based on different levels of risk. An investment in a mortgage-backed CDO, therefore, is an investment in the possibility of repayment of the mortgages along with

the associated risk, not an investment in the mortgage itself. Ideally, the diversification of high risk subprime mortgages combined with lower-risk mortgages would generally reduce the overall risk of such securities. However, many CDOs have a large stake in only subprime mortgages. Although riskier investments yield higher returns, the potential for default on a subprime mortgage is significant and can lead to enormous losses.

FN2. Kabir Chibber, 'Banks May Have to Boost Loss Reserves, Moody's Says (Update 1),' Bloomberg, Jan. 7, 2008.

FN3. See [15 U.S.C. §77k\(a\)](#).

FN4. See [In re Flag Telecom Holdings, Ltd. Sec. Litig., 411 F.Supp.2d 377, 382 \(S.D.N.Y. 2006\)](#) (acknowledging that a plaintiff is not required to plead loss causation to establish a prima facie claim under §11 of the Securities Act).

FN5. [In re Dynegy Inc. Sec. Litig., 339 F.Supp.2d 804, 867-68 \(S.D. Tex. 2004\)](#).

FN6. [544 U.S. 336 \(2005\)](#).

FN7. See, e.g., [Levine v. AtriCure Inc., 508 F.Supp.2d 268, 272-73 \(S.D.N.Y. 2007\)](#); *In re Portal Software Inc. Sec. Litig.*, No. C-03-5138 VRW, 2006 U.S. Dist. LEXIS 61589, at \*9 (N.D. Cal. Aug. 17, 2006).

FN8. [508 F.Supp.2d 268, 272-74 \(S.D.N.Y. 2007\)](#).

FN9. [Id. at 270-71](#).

FN10. [Id. at 271](#).

FN11. [Id. at 270-71](#).

FN12. [Id. at 271](#).

FN13. [Id. at 273](#) (citing *Adair v. Kaye Kotts Assocs.*, No. 97 Civ. 3375 (SS), 1998 U.S. Dist. LEXIS 3900, at \*24 (S.D.N.Y. March 27, 1998)).

FN14. *Id.*

FN15. *Id.* at 272.

FN16. *Id.*

FN17. *Id.* at 272-273

FN18. *Id.* at 272.

FN19. See *id.* (citing [Globus v. Law Research Serv. Inc., 418 F.2d 1276, 1288 \(2d Cir. 1969\)](#)).

FN20. [272 F.Supp.2d 243, 253-54 \(S.D.N.Y. 2003\)](#).

FN21. [Id. at 254.](#)

FN22. Id.

FN23. Id. at 253.

FN24. Id. at 254.

FN25. [AtriCure, 508 F.Supp.2d at 273.](#)

FN26. See, Id.

FN27. No. 8:04-cv-2561-T-24 EAJ, 2006 U.S. Dist. LEXIS 11527, at \*77-\*79 (M.D. Fla. March 6, 2006).

FN28. Id.

FN29. Id. at \*75.

FN30. See [In re Alamosa Holdings Inc. Sec. Litig., 382 F.Supp.2d 832, 866 \(N.D. Tex. 2005\)](#); [In re McKesson HBOC Secs. Litig., 126 F.Supp.2d 1248, 1262 \(N.D. Cal. 2000\)](#).

FN31. [AtriCure, 508 F.Supp.2d at 273 n.5.](#)

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