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ALERT MEMORANDUM

Recent New York Decision Highlights Challenges Plaintiffs Will Face in Proving Loss Causation for Securities Fraud Cases Brought Following a Crisis

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The economic disruptions caused by COVID-19 are causing many to question whether a new wave of investment losses are on the horizon and whether a corresponding wave of investor-led litigation reminiscent of financial crisis era litigation will follow. In a significant decision for defendants, the New York Supreme Court Commercial Division recently reminded would-be plaintiffs of the challenges of proving a fraud claim arising out of investment losses in times of crisis; critically, it requires proving that the alleged fraud – and not the intervening crisis – caused the plaintiff's loss.

On Friday, May 8, 2020 the New York Supreme Court Commercial Division entered an order granting summary judgment in favor of Merrill Lynch, dismissing an investor plaintiff's fraud claim arising out of its investment in a 2006 collateralized debt obligation ("CDO") that had been arranged by Merrill Lynch.[1] The court dismissed the plaintiff's claim because the plaintiff failed to raise a triable issue of fact demonstrating that its investment losses in the CDO were caused by Merrill Lynch's alleged misrepresentations or omissions, as opposed to the broader 2007-2009 financial crisis that affected the entire CDO market. This decision, arising from the financial crisis of over a decade ago, highlights the significant hurdle for investors contemplating securities fraud actions arising out of the COVID-19 pandemic.

[1] Cleary Gottlieb represented Merrill Lynch in this action, *Loreley Financing (Jersey) No. 3 Ltd. v. Lynch*, No. 652732/2011, 2020 WL 2302989 (N.Y. Sup. Ct. Apr. 02, 2020).

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The Case

Causation was one of the primary elements at issue in *Loreley Financing (Jersey) No. 3 Ltd. v. Lynch*, No. 652732/2011, 2020 WL 2302989 (N.Y. Sup. Ct. Apr. 02, 2020).[2] To succeed on a fraud claim, a plaintiff must show two types of causation. The first is transaction causation, which requires "that defendant's misrepresentation induced plaintiff to enter into the transaction." *Id.* at *7. The second is loss causation, which requires that the "subject of the fraudulent statement or omission was the cause of the actual loss suffered." *Id.* (quoting *Basis PAC-Rim Opportunity Fund (Master) v. TCW Asset Mgt. Co*. 149 A.D.3d 146, 149 (1st Dep't 2017)).

In *Loreley Financing (Jersey) No. 3*, the plaintiff, a special purpose vehicle, invested $60 million in the Auriga CDO ("Auriga") in December 2006. Following the financial crisis, Auriga defaulted and the plaintiff lost its investment. The plaintiff alleged that defendant Merrill Lynch and co-defendant 250 Capital LLC, Auriga's collateral manager, concealed a hedge fund's role in structuring Auriga and selecting its collateral portfolio. According to the complaint, Merrill Lynch, 250 Capital, and the hedge fund selected toxic collateral for Auriga, and misled the plaintiff about doing so. This allegedly toxic collateral was supposedly more likely than other CDO collateral to default.

According to the complaint, the hedge fund was incentivized for Auriga to fail because of its large short positions against Auriga; and Merrill Lynch and 250 Capital were alleged to have allowed the hedge fund to influence Auriga's structure and portfolio in order to generate fees and sustain a valuable business relationship with the hedge fund.

However, when discovery confirmed that the collateral in Auriga performed no worse than other comparable collateral, the plaintiff shifted its theory of loss causation. On summary judgment the plaintiff abandoned the claim that Auriga's collateral was unusually toxic and performed worse than other collateral, and instead argued that (1) it would not have purchased the Auriga notes if it had known about the hedge fund's undisclosed involvement (transaction causation) and (2) it overpaid for the Auriga notes the day of purchase, because disclosing the hedge fund's involvement at the outset would have rendered the CDO notes unmarketable and therefore valueless (loss causation). Under the plaintiff's theory, it suffered a loss not when Auriga's allegedly toxic assets defaulted, but the moment it paid $60 million for something that was really worth $0. Indeed, the plaintiff's expert testified that: "even if Auriga continued to perform post-closing as Loreley expected and then Loreley sold its Auriga notes for full purchase price a month after closing, the misrepresentations and omissions regarding [the hedge fund's role in Auriga] still caused Loreley harm in the amount of its total investment." *Id.* at *19. The ultimate performance of the Auriga CDO was thus irrelevant under this overpayment theory of loss causation.

The court rejected the plaintiff's argument, recalling basic principles of loss causation and relying on the First Department's decision in *Basis*

[2] The court also granted summary judgment on the independent ground that the plaintiff failed to establish actual reliance on any alleged misrepresentation or omission. Discovery showed that the plaintiff's directors were solely responsible for approving investment in Auriga, never received any statements, including offering documentation, from the defendants, and based their approval only on the recommendation of a third-party investment adviser. Because the investment adviser did not act as a conduit in conveying the defendants' statements about Auriga to the plaintiff, the defendants' statements to the investment adviser were irrelevant to proving reliance.

PAC-Rim. In *Basis Pac-Rim*, the First Department held that "when the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors [e.g., the 2008 financial crisis], the prospect that the plaintiff's loss was caused by the fraud decreases, and a plaintiff's claim fails when it has not . . . proven . . . that its loss was caused by the alleged misstatements as opposed to intervening events." *Id.* at *8 (quoting *Basis Pac-Rim*, 149 A.D.3d at 149). Following the U.S. Supreme Court's decision in *Dura Pharms., Inc. v. Broudo*, 544 US 336 (2005), the court in *Loreley Financing (Jersey) No. 3* held that the plaintiff's claimed "overpayment" was irrelevant to the question of loss causation in a securities fraud case, where the court looks to the "causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." *Id.* at *9. While overpayment may be relevant to measuring damages once loss causation is proven, "a damages calculation [is] not a proof of proximate or loss causation." *Id.*

Implications for COVID-19 Fraud Cases

In light of the steep market decline beginning in March 2020 and multi-sector slowdown, there is much speculation of an eventual rise in related securities litigation. Similarly, some have speculated that CLOs in particular are at heightened risk of underperformance and default, suggesting they might experience a similar fate as CDOs during the 2007-2009 financial crisis. *See* Financial Times, *CLOs: ground zero for the next stage of the financial crisis?*, Joe Rennison and Robert Smith (May 13, 2020). *Loreley Financing (Jersey) No. 3* is a strong reminder that investors who suffer losses on their investment in the wake of the COVID-19 crisis will face the significant challenge of pleading and ultimately proving that their loss was caused by an alleged fraud or some other misconduct, and not the result of the broader market downturn. This task will likely be made more difficult for CLO investors in the current crisis, considering that, unlike during the 2007-2009 financial crisis, this time it is a virus, and not structured finance products, that is at the heart of the downturn.

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