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Trends In Subprime-Related Securities Fraud Actions

Law360, New York (October 31, 2008) -- We are now well into the second year of the subprime litigation blitz and, to date, more than 100 subprime-related securities cases have been filed. Courts are nevertheless only just beginning to decide motions to dismiss.

Indeed, barely more than a handful of decisions on such motions have come down in putative class actions alleging subprime-related securities fraud.

Of these, most have favored defendants: two granted dismissal with prejudice (In re 2007 NovaStar Fin., Inc. Sec. Litig., No. 07-139, 2008 WL 2354367 (W.D. Mo. June 4, 2008); In re Impac Mortgage Holdings, Inc. Sec. Litig., 554 F. Supp. 2d 1083 (C.D. Cal. 2008)), and three granted dismissal with leave to amend (Tripp v. IndyMac Fin., Inc., No. 07-1635, 2007 WL 4591930 (C.D. Cal. Nov. 29, 2007); Gold v. Morrice, No. 07-931, 2008 WL 467619 (C.D. Cal. Jan. 31, 2008); Patel v. Parnes, No. 07-5364, 2008 WL 2803076 (C.D. Cal. May 19, 2008)).

Two other decisions sustained plaintiffs' complaints. See Atlas v. Accredited Home Lenders Holding Co., 556 F. Supp. 2d 1142 (S.D. Cal. 2008); City of Hialeah Employees' Ret. Sys. & Laborers Pension Trust Funds v. Toll Brothers, No. 07 1513, 2008 WL 4058690 (E.D. Pa. Aug. 29, 2008); see also In re Countrywide Fin. Corp. Derivative Litig., 554 F. Supp. 2d 1044 (C.D. Cal. 2008) (sustaining derivative complaint, in part).

Because of the relative dearth of decisions thus far, limited conclusions about the law in this area can be drawn.

Four recent rulings suggest that allegations of scienter and loss causation are front and center in courts' analyses of subprime-related securities class action complaints.

The decisions in Impac, NovaStar, and Accredited Home Lenders provide guidance regarding the specificity with which subprime plaintiffs must allege scienter. And the

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outcome in Toll Brothers raises questions about how strictly courts in subprime cases will interpret the standard for pleading loss causation.

Pleading Scienter In Subprime-Related Securities Class Actions

The failure to satisfy the requirements for pleading scienter under the Private Litigation Securities Reform Act of 1995 has figured prominently in courts' analyses underlying the dismissals to date.

In Impac, according to plaintiffs, defendants publicly stated that they were implementing remedial measures to address the defendant real estate company's inadequate controls and procedures when, in fact, the company "had no intention of implementing meaningful changes." 554 F. Supp. 2d at 1094.

In support of this theory, plaintiffs cited "former employees" hired by Impac to help implement these measures, who allegedly had "some direct contact" with two of the individual defendants and who anonymously claimed that Impac had failed to effectuate their recommended changes. Id.; id at 1099-1100.

The court rejected these scienter allegations, finding that they "fail[ed] ... to establish any connection between the [former employees'] contentions" and the "knowledge and intent" of these individual defendants "at the time they made the remedial measures statements." Id. at 1099.

Plaintiffs further alleged that an individual defendant's statements expressing optimism about "future loan production and expectations" demonstrated scienter because the defendant "knew that Impac was not properly monitoring the quality of its loans and ... was operating in a 'do any deal' culture" and, therefore, also knew that "Impac's new loans would be non-performing." Id. at 1096.

But even if this defendant had been "aware that Impac was taking on increasingly risky loans," the court reasoned, "this fact does not establish that he was being deceitful in stating that he anticipated solid loan acquisition." Id. at 1100.

In short, the court held that plaintiffs' "voluminous conclusory allegations" regarding certain defendants' "knowledge or deliberate recklessness" did not "show that they were notified of information that would have led them to believe that any of the challenged statements were false when made." Id. at 1101.

In light of the dismissal without prejudice of NovaStar, subprime-related securities fraud complaints that "create an illusion of detail" and "insinuate the existence of fraud" are similarly unlikely to survive a motion to dismiss. NovaStar, 2008 WL 2354367, at *2.

In NovaStar, plaintiff claimed that the defendant finance company (which originated, purchased, and invested in residential subprime mortgages) and three of its officers had

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intentionally concealed that NovaStar lacked internal controls, failed to properly account for its allowance of loan losses, and deviated from underwriting standards.

Plaintiff alleged that an inference of fraudulent intent arose from defendants' regular attendance at meetings at which "the adverse effects of policy changes," the deterioration of the "Company's financial position, and ways to improve the Company's operations were discussed." Id. at *4.

The court disagreed, deeming such conduct "normal and expected," and plaintiffs' allegations "more consistent with a company and executive confronting a deterioration in the business and finding itself unable to prevent it than ... with a company and executives recklessly deceiving the investing community." Id.

The decisions in Impac and NovaStar should not be read, however, to suggest that defendants will escape the current onslaught of subprime litigation unscathed.

As noted above, plaintiffs have defeated motions to dismiss two subprime-related securities fraud class actions to date.

One such action is Atlas v. Accredited Home Lenders Holding Co., 556 F. Supp. 2d 1142 (S.D. Cal. 2008), in which plaintiffs claimed that the defendant subprime-mortgage lender, its indirect subsidiary REIT, and several individuals had, among other things, (i) publicly represented that they had been adhering to tight underwriting standards for subprime loans, when in fact they had disregarded underwriting standards in an effort to increase the volume of loans, and (ii) manipulated earnings by inadequately reserving for mortgage defaults, for potential losses on the eventual sale of real estate owned, and for repurchase losses on mortgages sold to third-party investors. Id. at 1149-52.

Unlike in Impac and NovaStar, the Accredited Home Lenders plaintiffs alleged "in detail" defendants' knowledge of departures from the company's underwriting standards, and they juxtaposed such knowledge with defendants' public statements regarding Accredited's compliance with those standards. Id. at 1156.

For example, plaintiffs cited a system that Accredited had implemented prior to the class period to "monitor management overrides or underwriters' rejection of loans for failing to comply with the company's underwriting criteria," as well as periodic reports during the class period that included "detailed information about widespread deviations from company policy and the adverse effect such practices were having on Accredited." Id.

Not surprisingly, the court held that these allegations (and others) "sufficiently support[ed]" an inference of scienter on the part of the company and certain of the individual defendants. Id. at 1156-57; see also Countrywide, 554 F. Supp. 2d at 1057 (finding a "cogent and compelling inference" that the individual defendants had "misled the public with regard to the rigor of Countrywide's loan origination process, the quality of its loans, and the company's financial situation" because they "realized that Countrywide had virtually abandoned its own ... loan underwriting practices.").

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By the time the market began to react significantly to concerns about subprime mortgages, many corporate holders and purveyors of mortgage-backed securities had already seen their share prices fall steadily for months or even years.

This fact alone may complicate efforts to plead and prove loss causation in subprime-related securities cases. See, e.g., Lentell v. Merrill Lynch & Co., 396 F.3d 161, 174 (2d Cir. 2005) (noting that the likelihood of demonstrating loss causation decreases if a "plaintiff's loss coincides with a market-wide phenomenon.") (internal citations omitted).

The Eastern District of Pennsylvania's recent decision in Toll Brothers may nevertheless offer some hope to plaintiffs.

In Toll Brothers, plaintiffs alleged that the defendant home builder and numerous individual defendants had intentionally concealed a softening demand for Toll Brothers homes. 2008 WL 4058690, at *2.

In pleading loss causation, plaintiffs pointed to four public statements over a three-month period that, according to plaintiffs, "gradually revealed" the truth about the lack of traffic and demand. Id. at *5.

Defendants decried this approach as "inappropriately group[ing] ... the alleged 'revelations' together in an attempt to establish loss causation." Id. The court sided with plaintiffs, deeming "each of the four revelations ... and subsequent drop in stock price" actionable. Id.

This holding seems out of step with certain earlier decisions rejecting the notion of gradual disclosure, or gradual loss in share price, in favor of a stricter rule requiring any such loss to follow closely on the heels of a corrective disclosure. See, e.g., 60223 Trust v. Goldman, Sachs & Co., 540 F. Supp. 2d 449, 461 (S.D.N.Y. 2007) (dismissing action on loss causation grounds because "[t]he loss in value of the stock occurred gradually over the course of the entire class period.").

Toll Brothers does align, however, with the Ninth Circuit's ruling (less than a month earlier) in Gilead Sciences Sec. Litig., 536 F.3d 1049 (9th Cir. 2008), which reversed the dismissal, on loss causation grounds, of a complaint alleging that "a public revelation on August [7, 2003] caused a price drop three months later on October 28." Id. at 1057.

Though not a subprime-related securities case, Gilead will apply to such cases in the Ninth Circuit.

The Gilead court reinstated plaintiffs' allegations that the defendant biopharmaceutical company and its top officers had "implemented a scheme" – beginning some two years before the stock drop at issue – "to promote" a certain antiretroviral agent by

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"aggressively marketing" that agent "for off-label uses" in violation of the Federal Food, Drug, and Cosmetic Act. Id. at 1051.

By means of this marketing campaign, defendants allegedly "inflated sales" illegally "and artificially inflated demand for" that agent, Viread. Id. at 1052.

Defendants supposedly then stated publicly that Gilead's positive second quarter 2003 financial results were "driven primarily by strong sales growth of Viread." Id.

On August 7, 2003, the FDA publicly disclosed a warning letter that chastised Gilead for making "oral statements that minimized the risk information and broadened the indication for Viread." Id. at 1053.

As reflected in Gilead's high share price on Aug. 7 and 8, though, investors "did not find [the warning letter] ... very significant." Id. at 1053. But physicians and wholesalers did note its importance, and "unbeknownst to investors," the remainder of August witnessed a "marked drop in prescriptions and sales." Id.

Gilead nevertheless "persisted in emphasizing the increased volume of Viread's second quarter sales." Id.

On Oct. 28, 2003, Gilead announced disappointing third quarter financial results, which market analysts "attributed to lower end-user demand." Id. at 1054 (internal citations omitted). According to plaintiffs, that lower end-user demand was "a direct result of the [July 29] warning letter, which had exposed Gilead's unlawful off-label marketing efforts to physicians." Id.

In reversing the district court, the Ninth Circuit credited plaintiffs' allegations that, when "the truth" about defendants' longstanding "off-label marketing" was disclosed, Gilead and its officers "could no longer maintain the sales growth levels that investors had come to expect, and Gilead's stock price dropped accordingly." Id. at 1056.

Thus, under Gilead, a "limited temporal gap between the time a misrepresentation is publicly revealed and the subsequent decline in stock value does not render a plaintiff's theory of loss causation per se implausible." Id. at 1058.

Although subprime cases in the Ninth Circuit will, of course, be subject to Gilead's decidedly pro-plaintiff loss causation standard, the extent to which courts in subprime cases elsewhere will revert to the stricter loss causation rule of 60223 Trust, or, alternatively, apply the more relaxed standard employed in Toll Brothers and Gilead, remains to be seen.

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