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IN RE *MERRILL LYNCH & CO., INC. RESEARCH REPORTS SECURITIES LITIGATION*

(decided August 12, 2003)

PATRICK G. DIAMOND*

In the world of gambling, the house always wins. The recent decision handed down by Judge Milton Pollack of the United States District Court for the Southern District of New York in *In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation*[1] illustrates the increasingly difficult landscape facing today's plaintiff classes in securities fraud class action lawsuits. The court's description of the marketplace as a "freewheeling casino"[2] serves as a warning sign that the cards are stacked against plaintiffs who turn towards litigation to recover monetary losses from the securities markets in the aftermath of the burst of the internet or dot.com bubble. The court reminds plaintiffs that the Private Securities Litigation Reform Act of 1995 ("PSLRA")[3] sets strict pleading requirements that must be met if a claim is to survive a motion to dismiss pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure.[4] This Comment focuses on the court's discussion of loss causation in securities fraud lawsuits;[5] specifically criticizing the court's holding that an

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1. 273 F. Supp. 2d 351 (S.D.N.Y. 2003) [hereinafter *In re* Merrill Lynch].
2. *Id.* at 358.
3. 15 U.S.C. § 78u-4 (1995). *See* Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers,* 51 BUS. LAW. 1009 (1996) (stating that the PSLRA made additions to the Securities Act of 1934 and is the first comprehensive revision of the federal securities laws governing private securities litigation since their enactment as part of the New Deal).
4. FED R. CIV. P. 12(b)(6) (Rule 12(b)(6) is a motion to dismiss for failure to state a claim upon which relief can be granted.
5. *See generally* Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 96 (2d Cir. 2001) (noting that "loss causation [is similar] to the tort concept of proximate cause, meaning that in order for the plaintiff to recover it must prove the damages it suffered were a foreseeable consequence of the misrepresentation."). *See also* David S. Escoffery, *A Winning Approach To Loss Causation Under Rule 10B-5 In Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA"),* 68 FORDHAM L. REV. 1781 (2000) (containing a detailed history and analysis of loss causation).

intervening cause, such as the burst of the dot.com bubble, can break the causal nexus between a defendant's wrongdoing and a plaintiff's injury. A potential impact of the court's holding is a limitation of plaintiff's statutory rights by creating an inability to successfully plead loss causation when plaintiff's monetary losses coincide with a marketwide phenomenon.

In June of 2001, the New York Attorney General's Office began an investigation into stock recommendations issued by research analysts[6] across the securities industry, and took an in depth look at recommendations made by the internet research analysts at Merrill Lynch and other financial institutions.[7] The investigation led to several findings including that:

> [s]ince late 1999, the internet research analysts at Merrill Lynch had published ratings for internet stocks that were misleading because: (1) the ratings in many cases did not reflect the analysts' true opinions of the companies; (2) as a matter of undisclosed, internal policy, no "reduce" or "sell" recommendations were issued, thereby converting a published five-point rating scale into a de facto three point system; and (3) Merrill Lynch failed to disclose to the public that Merrill Lynch's ratings were tarnished by an undisclosed conflict of interest: the research analysts were acting as quasi-investment bankers[8] for the companies at issue, often initiating, continuing, and/or manipulating research coverage for the purpose of attracting and keeping investment banking clients, thereby producing

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6. A research analyst is a financial professional who has expertise in evaluating investments. He/she typically employed by brokerage firms, investment advisors, or mutual funds. Analysts put together buy, sell, and hold recommendations on securities. Analysts usually specialize in specific industries or sectors to allow for comprehensive research, (definition available at http://investopedia.com/terms/a/analyst.asp.

7. Affidavit of Eric R. Dinallo in the matter of An Inquiry by Eliot Spitzer, Attorney General of the State of New York, with regard to Merrill Lynch & Co., Inc. at 2 (April, 2002) [hereinafter Dinallo Affidavit]. "The Dinallo affidavit was offered in support of an application before the New York state courts for an order, pursuant to New York state law, requiring Merrill Lynch employees to turn over documents and give testimony in the Attorney General's continuing investigation." *In re Merrill Lynch*, 273 F. Supp. 2d at 357 (2003).

8. An investment banker is a person representing a financial institution that is in the business of raising capital for corporations and municipalities, (definition available at http://investopedia.com/terms/i/investmentbanker.asp).

> misleading ratings that were neither objective nor independent, as they purported to be.[9]

These findings were made public in April of 2002 in an affidavit filed by the Attorney General's Office in New York State Supreme Court.[10]

Plaintiffs, who were investors in two of the many internet companies that Merrill Lynch's research analysts covered — 24/7 Real Media ("24/7") and Interliant,[11] brought a class action suit "[alleging] that the analyst opinions expressed in the research reports were materially misleading and violated Section 10(b)[12] of the Securities Exchange Act of 1934 and Rule 10(b)(5)[13] promulgated

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9. Dinallo Affidavit at 3. (the Attorney General's Investigation led to a $1.4 billion settlement with numerous securities firms due to discovered conflict of interests discovered and tainted research reports that were made public.) Press Release, Securities and Exchange Commission, *Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking* (April 28, 2003), available at http://www.sec.gov/news/press/2003-54.htm.

10. *See generally* Dinallo Affidavit.

11. *In re Merrill Lynch,* 273 F. Supp. 2d at 359. "The 24/7 and Interliant cases were only two out of approximately 27 consolidated actions" assigned to the United States District Court for the Southern District of New York by the Multidistrict Panel for consolidated administration. "Each of the actions consolidates cases pertaining to a single issuing company (internet stock) or investment fund. The 25 actions that are not the subject of the instant motion [were] stayed pending resolution of the legal issues raised in the 24/7 and Interliant motions." *Id.* at 359 n. 14.

12. 15 U.S.C. § 78j(b) (1994). Rule 10(b) states: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." For an allegation under SEC Rule 10b-5 to be sustained, a plaintiff must show that "in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material misrepresentation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused plaintiff's injury. Suez Equity Investors, L.P., v. Toronto-Dominion Bank, 250 F.3d 87, 95 (2d Cir. 2001) (citing Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 534 (2d Cir. 1999)).

13. 17 C.F.R. § 240.10b-5 (1998). Rule 10(b)(5) states: It shall be unlawful for any person, directly or indirectly, by the use of any means instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or (c)

thereunder by the Securities and Exchange Commission."[14] Plaintiffs filed suit soon after the affidavit of the New York Attorney General's Office was made public, and they relied heavily on the affidavit for support of their allegations.[15] Defendant Merrill Lynch moved to dismiss the class action complaint for failure to state a claim pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, and for failure to plead fraud with particularity, "as required by the Private Securities Litigation Reform Act of 1995 and Rule 9(b) of the Federal Rules of Civil Procedure."[16] The court granted defendant's motion stating that "[p]laintiffs have failed to adequately plead that defendant and its former chief internet analyst *caused* their losses. The facts and circumstances . . . show . . . that plaintiffs brought their own losses upon themselves when they knowingly spun an extremely high-risk, high-stakes wheel of fortune."[17] (emphasis in the original).

To bring a successful claim under the federal securities laws, in addition to proving, *inter alia,* intent to make a false material misrepresentation or omission of fact in connection with the purchase or sale of a security,[18] a plaintiff must satisfy the two-prong pleading requirement of causation: transaction causation,[19] "i.e., but for the fraudulent statement or omission, the plaintiff would not have entered into the transaction,"[20] and loss causation,[21] "i.e., the subject of the fraudulent statement or omission was the cause of the actual loss suffered."[22]

None of the plaintiffs in *In re Merrill Lynch* alleged to have read the analyst reports themselves, nor were they customers of Merrill

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To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

14. *In re Merrill Lynch*, 273 F. Supp. 2d at 359.

15. *Id.*

16. *Id.* at 355.

17. *Id.* at 358.

18. 15 U.S.C. § 78j(b) (1994).

19. Transaction causation is based upon the plaintiff's reliance upon the defendant's deceptive statements or omissions; that is, but for such conduct by the defendant, the plaintiff would not have acted to his detriment. Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 96 (2d Cir. 2001).

20. *Id.* at 95.

21. *Id.* at 96.

22. *Id.* at 95.

Lynch.[23] To get around this fact, plaintiffs alleged reliance through the fraud-on-the-market theory, which hypothesizes that "in an open and developed securities market, the price of a stock is determined by the available material information. . .misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements."[24] Under this theory, investors rely upon the integrity of the market price and all the information that the market price represents. Once a securities transaction is entered into, reliance on the market price is presumed to be reliance on any and all information, including any misstatements. As such, plaintiffs sufficiently pleaded the first prong of causation – transaction causation.

Plaintiffs, however, did not sufficiently plead the second prong of causation – loss causation.[25] The loss causation provision states:

> In any private action arising under this title, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages.[26]

The court utilized its own tri-partite analysis to illustrate the insufficiency of plaintiff's allegations. Part one addressed that "alleging 'artificial inflation' is not sufficient to satisfy loss causation."[27] Plaintiffs argued that Wall Street's investment bankers and research analysts were responsible for inflating stock prices through a "classic stock market manipulation" scheme based upon the overly optimistic ratings and the omission that conflicts of interests existed,

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23. *In re Merrill Lynch*, 273 F. Supp. 2d at 359.

24. Basic v. Levinson, 485 U.S. 224, 241-42 (1988). *See* Julie A. Herzog, *Fraud Created the Market: An Unwise and Unwarranted Extension of Section 10(b) and Rule 10b-5*, 63 GEO. WASH. L. REV. 359, 367 (1995) (stating that fraud-on-the-market theory "assumes that in an efficient market, the market has imputed into the stack price all publicly available material information. Because of this phenomenon, courts presume reliance of the plaintiff on the market price.").

25. Loss causation was "developed exclusively out of case law and was never expressly recognized by the Supreme Court," however, Congress codified loss causation when it enacted the PSLRA in 1995 and made it applicable to all securities fraud suits. *In re Merrill Lynch*, 273 F. Supp. 2d at 362 *citing* David S. Escoffery, Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 FORDHAM L. REV. 1781, 1781 (2000).

26. 15 U.S.C. § 78u-4(b)(4).

27. *In re Merrill Lynch*, 273 F. Supp. 2d at 364.

and it was this scheme that created the internet bubble.[28] The court noted, however, that "[e]ven if there was a claim that the misconduct caused the purchase price of the stocks to be artificially inflated, plaintiffs have failed to allege facts (as opposed to legal conclusions) from which to infer that the alleged omissions were a substantial cause of any inflation."[29] The court also noted that "[t]here is no factual predicate or legitimate inference from facts alleged. . .for plaintiffs' semantic invention of a stock market manipulation for internet company securities."[30]

The court's second stage of analysis focused on the inapplicability of the "fraud on the market theory" to loss causation.[31] As noted earlier, "fraud on the market theory" is a device that allows plaintiffs to satisfy the reliance aspect of transaction causation.[32] However, Second Circuit cases have split on whether to allow plaintiffs to utilize this theory to satisfy both transaction causation and loss causation.[33] Here, the court stated that "[t]o permit plaintiffs to allege artificial inflation through the fraud on the market theory to satisfy loss causation would improperly conflate both the 'but for' transaction causation and the loss causation elements into one."[34] The court cites to the Eleventh Circuit's decision in *Robbins v. Kroger Props, Inc.*[35] for support on this particular point. In *Robbins*, the court held that plaintiffs, despite successfully showing that defendant's actions caused the price of the stock in question to be artificially inflated, needed more to satisfy loss causation.[36]

The third stage analyzed the burst of the internet bubble as an intervening cause that serves to negate any casual link between the defendant's misrepresentations and the plaintiff's damages. The

28. *Id.* at 362.

29. *Id.* at 363.

30. *Id.* at 362.

31. *Id.* at 365.

32. Basic v. Levinson, 485 U.S. 224, 241-42 (1988).

33. *See* Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189 (2d Cir. 2003) (stating that purchase-time disparity can not satisfy loss causation). *Cf. In re* Initial Public Offerings Sec. Litig., 241 F. Supp.2d 281, *and* Demarco v. Robertson Stephens, Inc., No. 03 Civ. 590 (GEL), 2004 WL 51232 (S.D.N.Y. Jan. 9, 2004) (holding that fraud-on-the-market theory can satisfy both transaction causation and loss causation).

34. *In re Merrill Lynch,* 273 F. Supp. 2d at 365.

35. 116 F.3d 1441 (9th Cir. 1997).

36. *Id.* at 1448.

court reasoned that the alleged omissions were not the proximate or legal cause of the plaintiff's damages but rather a marketwide phenomenon.[37] The court states that "[t]here was no casual connection between the burst of the bubble and the alleged omissions; it was the burst which caused the market drop and the resultant losses a considerable time thereafter when plaintiffs decided it was time to sell."[38] The court held that "when the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases."[39]

In re Merrill Lynch is a clear example of the often stringent pleading requirements of 10(b)(5) claims within the Second Circuit. The court, in order to avoid having the federal securities laws twisted into "a scheme of cost-free speculators' insurance"[40] where plaintiffs can seek to "lay the blame for the enormous Internet Bubble solely at the feet of a single actor, Merrill Lynch,"[41] requires specificity and particularity in alleging securities fraud. Conclusory allegations with no factual basis will be dismissed with prejudice.

The court's analysis of loss causation suggests that a plaintiff who utilizes a fraud on the market theory – such as those in *In re Merrill Lynch* – must be able to plead, and eventually prove, two things: (1) that the alleged misrepresentations and omissions caused a stock price to be artificially inflated at the time of purchase; and (2) that the defendant's misrepresentations and/or omissions also caused the stock price to decline. But, even if a plaintiff pleads both elements sufficiently, his claim(s) may still be dismissed if an intervening cause negates the causal link between the misrepresentations and/or omissions and plaintiff's damages.[42] It is this idea of an intervening cause which future courts should consider, for it allows defendants to hide behind a shield of judi-

37. *In re Merrill Lynch*, 273 F. Supp. 2d at 362.

38. *Id.*

39. Nationwide Bank v. Gelt Funding Corp., 27 F.3d. 763, 772 (2d Cir. 1994) c*ited in In re Merrill Lynch*, 273 F. Supp. 2d at 364.

40. *In re Merrill Lynch*, 273 F. Supp. 2d at 362.

41. *Id.*

42. *Robbins v. Kroger Props, Inc.*, 116 F.3d 1441, 1448 (9th Cir. 1997).

cially made law affording them added protection not envisioned by the PSLRA.[43]

The third stage of the courts tri-partite analysis of loss causation, as described above, focuses on the burst of the internet bubble and the resulting precipitous decline in stock market prices as the actual cause of plaintiff's damages.[44] It is perfectly logical that a defendant should not be responsible for a drop in stock prices when extraneous factors caused the actual loss.[45] However, by using an extremely complex marketwide phenomenon such as the bursting of a stock bubble[46] as an intervening cause, the court is essentially non-suiting plaintiffs in securities fraud cases that follow a market crash or bubble. The Eleventh Circuit Court of Appeals in *Robbins v. Kroger Props, Inc.*[47] addressed this very notion by stating that "because market responses, such as market downturns, are often the result of many different, complex, and often unknowable factors, 'the plaintiff need not show that the defendant's act was the sole and exclusive cause of the injury he has suffered; he need only show that it was 'substantial, i.e., a significant contributing

43. *See* David S. Escoffery, *A Winning Approach To Loss Causation Under Rule 10B-5 In Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 Fordham L. Rev. 1781, 1810-14 (2000) (describing the legislative history surrounding the enactment of the PSLRA. The author notes that the primary forces behind the legislation were accounting firms and related lobbyists who hoped to stem the tide of frivolous class action law suits brought by plaintiffs in order to extract lucrative settlements. Congress, however, did not wish to discourage the filing of meritorious claims).

44. *In re Merrill Lynch*, 273 F. Supp. 2d at 362.

45. *See Robbins*, 116 F.3d at 1441 (holding that the defendant company's stock price dropped when the investing public was made aware that there would be a decrease in the company's dividend due to a lack of income generation from real estate assets, not from accounting irregularities coming to light).

46. *See* Lawrence Lee Evans, Jr., Why the Bubble Burst: U.S. Stock Market Performance Since 1982, 208-10 (Malcolm C. Sawyer ed., Edward Elgar Publishing Limited 2003) (2003) (the author notes that a supply and demand theory explains the run-up of the stock market with numerous contributing factors including: "irrational exuberance" on the part of investors, corporate fundamentals, e.g., future dividend payments, foreign capital and mutual fund flows, as well as equity retirements from the secondary markets. Factors leading to the burst of the market bubble included: investor's inability to believe disproportionate company valuations, corporation's inability to retire more equity, slowdown in foreign and mutual fund flows, and disclosure of accounting irregularities leading to significant earnings restatements).

47. *Robbins*, 116 F.3d at 1447.

cause.' "[48] In fact, the United States Court of Appeals for the Second Circuit in *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*,[49] explicitly stated that "if the loss was caused by an intervening event, like a general fall in price of Internet stocks, the chain of causation will not have been established. But such is a matter of proof at trial and not to be decided on a *Rule 12(b)(6)* motion to dismiss."[50] (emphasis in original).

How are plaintiffs expected to prove what is and what is not a "substantial" cause when numerous factors are at play in a stock market bubble? And isn't the judiciary usurping the role of the legislature by adding yet another hurdle for plaintiffs to cope with in addition to the already difficult pleading requirements set forth by the PSLRA?

The *In re Merrill Lynch* court, distinguished plaintiffs with those in *In re WorldCom, Inc. Securities Litigation*,[51] stating that the WorldCom "plaintiffs alleged that the research reports were materially false and misleading because the analyst had failed to disclose material nonpublic information he possessed about the company and had purportedly concealed the company's true financial condition . . ."[52] This, presumably, would satisfy the "substantial" test laid out in *Robbins*. In *In re Merrill Lynch*, however, the underlying material supporting the research reports published by Merrill Lynch were not false or misleading, nor did the analysts try to conceal any of the corporation's financial data.[53] Should this fact alone be enough to distinguish these cases? After all, the Merrill Lynch reports publicly recommended that investors accumulate 24/7 stock, despite being described as a "piece of s__" within Merrill Lynch.[54] By applying the *Robbins* "substantial test," the *In re Merrill Lynch* plaintiffs would have to prove that the misrepresentations caused the decline in stock price in a substantial way. It is unclear what role, if any, the revelation of the true opinions of the analysts

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48. *Robbins*, 116 F.3d at 1447 (quoting Bruschi v. Brown, 876 F.2d 1526, 1531 (11th Cir. 1989)).

49. 343 F.3d 189 (2d Cir. 2003).

50. *Id.* at 197.

51. 294 F. Supp. 2d 392 (S.D.N.Y. 2003).

52. *In re Merrill Lynch*, 273 F. Supp. 2d at 364 n.25.

53. *Id.* at 360.

54. Dinallo Affidavit at 13.

played in the bursting of the internet bubble, but it is clear that isolating this factor from the countless other factors that contributed to the burst is a difficult task.

"[E]vidence suggests that investors are justified in pointing a collective finger at US corporations and the security industry [because] investors prone to speculative enthusiasms are unduly susceptible to misrepresentations, corporate fraud, and new economy concepts lacking true economic substance."[55] The dismissal in *In re Merrill Lynch* is a strong indication as to how the remaining cases, based on similar allegations, pending before the court will fair[56] and illustrates, once again, that the house wins.[57]

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55. LAWRENCE LEE EVANS, JR., WHY THE BUBBLE BURST: U.S. STOCK MARKET PERFORMANCE SINCE 1982, 2 (Malcolm C. Sawyer ed., Edward Elgar Publishing Ltd. 2003) (2003).

56. *In re Merrill Lynch,* 273 F. Supp. 2d at 359 n. 14.

57. Plaintiffs have filed an appeal with the United States Court of Appeals for the Second Circuit on September 12, 2003.