Pleading Securities Fraud with Particularity and Loss Causation

*Anchor Bank FSB v. Hofer*

Securities fraud cases have stringent pleading requirements. The Federal Rules of Civil Procedure 8(a) and Rule 9(b) require that plaintiffs state with particularity the circumstances constituting the fraud. The PSLRA also requires that plaintiffs allege with particularity the defendant’s state of mind and a cognizable theory of economic loss. 15 U.S.C. § 78u-4(b)(1)-(2), (4). The Seventh Circuit in *Anchor Bank FSB v. Hofer*, No. 10-3935 (7th Cir. Aug. 18, 2011), provides an example of a case in which the plaintiffs did allege, with sufficient particularity, securities law violations.

In *Anchor Bank FSB*, Anchor Bank and an investment fund sued an employee of the bank and two coconspirators for allegedly engaging in a collusive trading scheme in violation of Section 9(a) and Section 10(b) of the Securities Exchange Act of 1934. The plaintiff alleged the following facts: The defendant and his two coconspirators were allowed to invest in the investment fund because they were employees of the bank. The fund was a combination of stock and cash, and it generally maintains a cash-to-stock ratio of 5-to-11%. When fund participants buy and sell shares, the trustee of the fund must buy and sell the bank’s stock on the open market at exact times and in specific amounts to maintain the cash-to-stock ratio.

According to the plaintiffs, the defendant engaged in 36 collusive trades with coconspirators. The plaintiffs laid out the two-step fraudulent scheme. Step 1: the defendant and a coconspirator would sell...
fund shares, triggering a payout of cash, which in turn forced a sale of the bank’s stock at market prices. This caused the stock price to drop—it increased the amount of the bank’s stock in the market without an increase in demand. Step 2: The defendant bought stock on the open market, which caused the fund to buy shares on the open market to maintain its cash-to-stock ratio; the stock price increased. Once the stock price rose, the co-conspirators would sell their shares for profit. Over the course of the scheme, the trio owned 72% of the fund’s shares and increased the value of their holdings by 230-to-270% (without increasing their contribution to the fund). The stock price tumbled 95%, from $11 a share to 49 cents a share. These detailed allegations, the court said, were sufficient to satisfy the particularity pleading requirement.

Additionally, the court held that the allegations were sufficient to allege a strong inference of scienter. According to the court:

The plaintiffs-appellants alleged that [the defendant] concocted and executed a scheme whereby he would act in cahoots with two other AnchorBank employees to artificially inflate and deflate the value of Fund units and AnchorBank stock values . . . . The inference of scienter that is raised in the complaint remains strong in light of competing, plausible explanations offered by [the defendant], such as that he was simply following the rudimentary investment strategy of buying low and selling high.

The court continued the plaintiffs adequately alleged loss causation as well. The plaintiffs alleged that the fund traded stock in an open market in the wake of fraudulent, coordinated purchases and sales of the fund’s shares by the defendant and his coconspirators. The court noted that “the heightened activity on the market caused drastic increases and decreases in the AnchorBank stock price; [the defendant] and his coconspirators caused and amplified the dramatic stock fluctuations by repeating their Fund unit scheme 36 times.”

The court also addressed the defendant’s contention that because the fund’s trustee could space out the purchase and sale of stock to maintain the cash-to-stock ratio, then all the plaintiffs’ losses were not a result of the defendant’s fraud. The Seventh Circuit rejected this argument: “We do not require that a plaintiff plead that all of its loss is necessarily attributed to the actions of the defendant, only that it plead that the defendant is at least one plausible cause of the economic loss.” (citing Caremark, Inc. v. Coram Healthcare Corp., 113 F.3d 645, 649 (7th Cir. 1997), and Ray v. Citigroup Global Markets, Inc., 482 F.3d 991, 994-95 (7th Cir. 2007)).

The Seventh Circuit’s decision is available
here: