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Current Trends in Federal Securities Litigation

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I. INTRODUCTION

This last year has witnessed some of the most significant developments in securities class action jurisprudence in decades, led by the U.S. Supreme Court's very prominent interest in securities cases, and its decision to grant certiorari in two important cases involving pleading standards (*Tellabs*) and the scope of liability under Section 10(b) (*Charter Communications*)—cases that will shape private securities class action litigation for decades to come. Each of these cases is discussed in greater detail below. The importance of these issues is underscored by the aggressive lobbying that the plaintiffs' bar has undertaken to attempt to influence the Securities and Exchange Commission to support the granting of certiorari in the recent decision of the Fifth Circuit in the *Enron* litigation reversing the trial court's grant of class certification. Ironically, the SEC, through the Office of the Solicitor General, filed an amicus brief earlier this year in the *Tellabs* case, supporting a fairly rigorous pleading standard under the Private Securities Litigation Reform Act.

At the Court of Appeals level, a number of key decisions have been handed down in the past year interpreting and applying the Supreme Court's 2005 decision in *Dura Pharmaceutical,* in which the Court set the standards for pleading and proving loss causation. As discussed in Section VI below, the trend of these appellate rulings in the last year is decidedly pro-defense, and augers well for an increased rate of dismissals of securities class actions in the lower courts on loss causation grounds.

In 2006-07, the Courts of Appeal also issued decisions that create a clear conflict among the Circuits on the issue of how trial courts should evaluate class certification issues in securities cases. As discussed in Section V below, increasingly, the courts are adopting more rigorous standards for class certification, and authorizing trial courts to consider the "merits" of cases as they may effect class certification issues such as adequacy, typicality, and predominance of common issues such as reliance. As demonstrated in key decisions this last year from the Second and Fifth Circuits, class certification may now be where the "rubber meets the road" in cases going forward, and many defense counsel believe that this issue may be ripe for Supreme Court review next year.

In the last year, the courts have also continued to struggle with the issue of how state court class actions may run afoul of the Securities Litigation Uniform Standards Act ("SLUSA"). As reported below in Section VII below, a number of cases have come down that suggest that the plaintiffs' bar will continue to be creative in their attempts to circumvent SLUSA and bring securities cases in state court that do not belong there.

We begin this paper with a review of current trends in securities litigation affecting public companies and their auditors, and important reform initiatives currently underway to address the wide-spread concern that private securities litigation continues to impair the competitiveness of the U.S. capital markets.

II. 2006-07 SECURITIES LITIGATION REFORM EFFORTS

The past year has seen an increased focus on whether the U.S. capital markets are impaired by "over regulation," including reforms adopted as part of the Sarbanes-Oxley Act that arguably have led to more civil actions against public companies and their outside auditors. For the first time since SOX was enacted in 2001, there seems to be mounting concern that the pendulum has swung too far towards "over regulation" in the wake of the collapse of Enron, Worldcom, Adelphia and other companies, and that the net effect has been adverse to economic growth in America. As discussed below, a number of significant reform proposals are now being advanced by various constituencies within the U.S. capital markets, with one common theme—the U.S. needs to take bold steps to avoid the "flight" of capital to foreign markets, and a corresponding loss of competitiveness.

A. Issues Affecting the Exposure of Public Companies and Their Officers and Directors

The headlines in 2006-07 have reported that the level of securities class action litigation in the federal court system has dramatically diminished in the last two years. Various experts have reported the statistics for 2006, and it is true that the sheer number of new class action filings was down in 2006 over the prior year. However, the decline in new filings of federal securities class actions obscures some other counter-veiling trends, a few of which are mentioned here.

First, despite the decline in new filings, the average settlement amount for securities class actions in 2006 was exceedingly large. According to one study, average settlements in 2006 were approximately $62 million—far higher than the average settlement amount two years ago of less than $28 million.

Second, the number of "mega" settlements increased dramatically in 2006 as a percentage of all settlements—19% were over $50 million last year, compared to 9% in 2005.

Third, the statistics reported in these studies do not include the scores of cases filed last year that related to stock option backdating—most of which were filed as "derivative" suits, and frequently brought in state court. As the financial press has reported extensively since 2006, companies are facing major suits over alleged "backdating" practices, often with parallel SEC and U.S. Attorney investigations.

Fourth, the number of cases in which directors and officers have been asked to contribute personal funds towards the settlement of the litigation increased in the last year, including out-of-pocket contributions from former officers of Tenet Healthcare and Krispy Kreme.

No one has a very good explanation for the decline in the number of new case filings in the last two years, and no one is seriously arguing that the era of "bet the company" securities litigation is over. On the contrary, the D&O insurance market remains vibrant in part because public companies and their directors continue to fear being sued in a securities class action lawsuit. Although one commentator has suggested that perhaps the explanation for the decline in suits is because the provisions of the Sarbanes-Oxley Act are actually working—and no doubt

there is some truth to that—the fact remains that the plaintiffs' bar is fully employed, and looking to convince the Supreme Court that it should liberalize the laws that allow these suits to be brought in the first place. The next year will provide important guidance on whether the contraction of the securities litigation market will continue or, as some fear, the flood gates will re-open following the Supreme Court's decisions in *Tellabs* and *Charter Communications*.

B. Issues Affecting the Exposure of "Big Four" Accounting Firms

1. Civil Claims Against Auditors Continue to Pose Liability Risks

The exposure of audit firms to large claims continues, although in 2006 the number of civil class actions alleging accounting fraud seems to have dropped from the levels of prior years,[1] and certainly has declined in relation to the number of accounting restatements reported by public companies in the last 24 months.[2] The data on how much accounting firms have paid to resolve private litigation and/or regulatory claims is not well compiled. There have a few "mega" settlements in 2006 in which significant settlement payments were made by accounting firms, including several settlements by now-defunct Arthur Andersen.[3] Moreover, according to one study released earlier this year, over 90% of all new class action suits filed in 2006 included allegations of false financial statements. The same study reported a sharp increase in the number of cases alleging specific accounting irregularities, from 44% in 2005 to 68% in 2006.[4]

At the same time, however, accounting firms have successfully moved to dismiss a number of class action cases brought them in the last 24 months, an indication that the PSLRA heightened pleading standards, combined with recent decisions narrowly construing the scope of primary liability under Section 10(b) of the 1934 Act, continue to deter at least some meritless claims against accounting firms.[5] Further, the United States Supreme Court will decide important issues over the liability of "secondary actors" sued under Section 10(b) of the Securities Exchange Act, in a case that is closely watched by the accounting profession.[6] If the Court affirms the Court of Appeals decision, the rate of securities class action cases against audit firms may diminish further. In the absence of more concrete reforms, however, audit firms no doubt will continue to face the prospect of catastrophic losses.

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1 According to the PricewaterhouseCoopers 2006 Securities Litigation Study, securities class action cases based on restatements declined from 82 in 2002 to only 37 in 2006. Similarly, the number of SEC Litigation Releases related to new accounting cases declined from 61 in 2002 to 30 in 2006.

2 "Glass, Lewis Analyst Says Restatements On Track to Set Another Record in 2006," Securities Regulation & Law (BNA) (Nov. 6, 2006).

3 Examples include Arthur Andersen's settlement of Enron-related class action claims for the sum of $72,500,000.

4 "Securities Class Action Case Filings: 2006, A Year in Review," at 19 (Cornerstone Research), available online at www.cornerstone.com.

5 *See, e.g., Ezra Charitable Trust v. Tyco International Ltd*, 466 F.3d 1 (1st Cir. 2006) (dismissing claims against PricewaterhouseCoopers notwithstanding Tyco's restatement of results, and holding, inter alia, that the mere fact of restatement does not give rise a strong inference of scienter).

6 *Stoneridge Insurance v. Scientific Atlanta,* docket no. 06-43 (cert. granted March 26, 2007).

2. Contractual Limitations on Auditor Liability

In some cases accounting firms have taken steps to allocate litigation risk by including indemnity agreements in their engagement letters with clients in certain circumstances. Existing AICPA ethics rules permit such indemnification if, for example, there were knowing misrepresentations by management.[7]

The SEC's position on this matter—at least as reflected in the Staff's answers to "Frequently Asked Questions" in 2004-- has been that an accountant's independence may be called into question if the accountant enters into an indemnity agreement with the registrant, if the indemnity purports to provide immunity to the accountant against liability for his or her own negligent acts. Likewise, the SEC has stated that indemnity agreements that protect auditors from liability caused by "knowing misrepresentations by management" may impair independence.[8]

During 2006, the AICPA began a process of reevaluating whether and to what extent audit firms may limit their liability through contractual indemnification agreements with their audit clients. The issue was brought forward most directly in an exposure draft issued by the AICPA's Professional Ethics Executive Committee in September 2005 that would allow auditors to limit liability under certain circumstances. Based on a limited number of comments received, the PEEC issued its proposed Interpretation 101-166 in September 2006. The proposed Interpretation would authorize audit firms to enter into indemnification agreements with their clients only if the audit firm has performed the audit services "in accordance with professional standards, in all material respects."[9] The proposed Interpretation found that certain other actions, however, would not impair independence, including 1) indemnification for punitive damages claims by third parties, 2) "reasonable" time limitations on when an audit client may sue the auditor, and 3) ADR provisions mandating arbitration of auditor malpractice or other claims.

The proposed Interpretation has been met with mixed reactions from the accounting profession. Several comment letters on the proposed Interpretation were critical of the conditions placed on indemnification, particularly given the vagueness of the "in accordance with professional standards" condition.[10] Hearings on the proposed Interpretation that were supposed to have been held on November 30-December 1, 2006 were taken off calendar.[11]

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[7] *See, e.g.,* AICPA Ethics Ruling 94.

[8] Application of the Commission's Rules on Auditor Independence—Frequently Asked Questions (December 13, 2004).

[9] A copy of the PEEC exposure draft is attached as Exhibit A.

[10] *See, e.g.,* December 8, 2006 comment letter from Deloitte & Touche. As well, the Technical Issues Committee of the AICPA objected to the proposed deletion of its Ethics Ruling 94.

[11] In the wake of the original PEEC exposure draft in September 2005, various federal agencies with regulatory authority over banking and financial institutions collaborated on an "Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters." This advisory declares it to be an "unsafe and unsound" practice for audit firms to use certain "limitation of liability" provisions in connection with audits of financial institutions.

Whether agency actions will affect the use of limitation of liability provisions in the future remains to be seen. In the meantime, the overarching issue remains, and audit firms continue to face liability risks without reliable protections against their own audit clients' misconduct.

3. The Challenge of "Principles-Based" Accounting

In 2002, as part of the enactment of the Sarbanes Oxley Act, Congress directed the SEC to report on efforts to move U.S. GAAP standards from the detailed "standards based" accounting rules now in place, to a more "principles-based" standard of accounting.[12] In July 2003, the SEC released its initial study on principles-based accounting. The SEC Study largely dismissed the concern over increased litigation risks that a "principals-based" accounting system might create. "We believe . . . that the concern over litigation uncertainty is sometimes overstated and may arise our of a confusion between principles-based and principles-only standards."[13]

Since issuance of the SEC Study, SEC officials have joined with the Financial Accounting Standards Board (FASB) and other market participants to study how to make the nation's accounting standards less complex.[14] In general, "principles based" accounting standards encourages the exercise of accounting judgment, rather than reliance on bright line rules and technical standards. The current GAAP system is based on a myriad of principles, rules, interpretations, and standards. This "standards-based" regime recently was described by former SEC Commissioner Cynthia Glassman as follows:

> The financial reporting landscape is littered with pronouncements from the FASB, the AICPA, the EITF, the APB, the SEC and the PCAOB. We have pronouncements, rules, regulations, guides, bulletins, audit standards, interpretations and practice aids in the form of SOPs, FAQs, SABs, Q&As and FSPs. This has been going on for decades. The result today, U.S. GAAP is made up of over 2,000 pronouncements. That's a lot of ABC's, even for a CEO or CFO with a CPA.[15]

In contrast to a "standards-based" accounting system, FASB Chairman Robert Herz described "principles-based" accounting this way:

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[12] *See* Section 108(d) of the Sarbanes-Oxley Act of 2002 (requiring the Commission to prepare the study on principles-based accounting by July 31, 2003).

[13] *See* Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (July 25, 2003).

[14] *See* Sec. Reg. & L. Rep. (BNA), (June 12, 2006); *see also* Sec. Reg. & L. Rep. (BNA) (June 19, 2006) quoting former SEC Commissioner Cynthia Glassman.

[15] Cynthia Glassman, former SEC commissioner, speaking at 25th Annual USC Leventhal School of Accounting SEC and Financial Reporting Institute Conference, Sec. Reg. & L. Rep. (BNA) (June 19, 2006).

> Under a principles-based approach, one starts with laying out the key objectives of good reporting in the subject area and provide them as guidance explaining the objectives and relating it to some common examples. While rules are sometimes unavoidable, the intent is not to try to provide specific guidance or rules for every possible situation. Rather, if in doubt, the reader is directed back to the principles.[16]

Supporters of a principles-based system believe it will foster a more nuanced exercise of accounting judgment. However, certain constituencies have expressed the fear that a "principles based system" may expose them to greater risk of litigation. Without technical standards to point to, these constituents fear that regulators and private plaintiffs' lawyers will have too much latitude to second guess an accountant's exercise of judgment.

SEC officials continue to assure the business community that a "principles-based" system will not result in "gotcha" enforcement actions,[17] but a number of senior executives and accounting professionals are still skeptical. According to a recent survey by CFO.com magazine, 36 percent of CFO's who oppose principles-based accounting cited the risk of major shareholder lawsuits as a reason for concern. "If principles-based accounting is going to work, we need to be presumed to be right," said one financial executive.[18] "The big concern is that we make a legitimate judgment based on the facts as we understand them, in the spirit of tying to comply, and that plaintiffs' attorneys come along later with an expert accountant who says, 'I wouldn't have done it that way,' and aha! – lawsuit! – several billion dollars, please."[19] "CFO's are second-guessed by auditors, who are then third-guessed by the Public Company Accounting Oversight Board [PCAOB], and then fourth- and fifth-guessed by the SEC and the plaintiffs' bar."[20] It is not yet clear that "principles" can stop this pattern of "Monday morning quarterbacking."

The SEC, the FASB, and the PCAOB all appear to have made principles-based accounting a priority issue for the next year. In 2006, principles-based accounting has been promoted in speeches by SEC Chairman Christopher Cox, SEC Commissioner Paul Atkins, FASB chairman Robert Herz, and former SEC deputy chief accountant Scott Taub.[21] On March 23, 2006, for example, Scott Taub, the SEC's then-acting chief accountant, said that he is "a little disheartened" because the implementation of the new "objectives-oriented standards" "to my

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16 Remarks of Robert H. Herz, FEI Current Financial Reporting Issues Conference, (Nov. 4, 2002).

17 Remarks of Linda Thomsen, SEC Director of Enforcement, 2006 Securities Regulation Institute (January 2006).

18 "Standing on Principles," CFO Magazine (September 1, 2006) quoting David Rickard, CFO of CVS Corp. and Financial Accounting Standards Advisory Committee ("FASAC") member, available at *http://www.cfo.com/article.cfm/7852613/c_7850066*.

19 *Id.*

20 *Id.* (quoting Colleen Cunningham, president and CEO of Financial Executives International).

21 "Standing on Principles," CFO Magazine (September 1,2006), available at *http://www.cfo.com/article.cfm/7852613/c_7850066*.

mind has not been principles-based."[22] In December 2006, the SEC's Chief Accountant, Conrad Hewitt, publicly declared that the issue of accounting complexity will be a leading topic of work by his office in 2007.[23] PCAOB Director of Registration and Inspection, George H Diacon, recently stated, "we shouldn't be second-guessing reasonable decisions made in the accounting field, however, PCAOB inspectors should challenge judgments that are not in the 'reasonable range.'"[24]

John White, director of the SEC Division of Corporation Finance, recently spoke to this topic. In response to the question, "what standard is used by Staff to determine when the company has complied with or failed to comply with principles-based regulation?" He said, "we understand that there is not a specific rule out there for every circumstance" and that the Staff will proceed "in good faith."[25] FASB Chairman Robert Herz seems to have acknowledged the issue when he remarked that "if it turns out some of the obstacles are hardwired into our structure, then maybe we need some legal changes as well."[26]

Will regulators be willing to consider some form of "safe harbor" for auditors exercising judgment under a new "principles-based" accounting system? At least one recent study urges such a solution. In November 2006, the Committee on Capital Markets Regulation made a number of recommendations for adjustments to our regulatory and litigation framework so that public markets are less burdensome. The Committee expressly recognized that regulators must reduce the risk of litigation to corporations, auditors, and outside directors, and specifically recommended that Congress consider enactment of safe harbors for certain auditing practices.[27]

Treasury Secretary Henry Paulson recently stated that auditors must be able to focus on ensuring the integrity and economic substance of management's financial statements. To get there, he said, accounting must be recognized as a profession, and not a science.[28] The goal Treasury Secretary Paulson suggests is an important one. More likely than not, the effort towards

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[22] "Top SEC Accountant Requests 'Principles-Based' Use of Rules," Securities Regulation & Law, (April 3, 2006).

[23] "SEC's Hewitt Says Accounting Complexity is 'High Priority' Issue for Agency in 2007," BNA Corporate Accountability, Vol. 4 No. 48 (December 15, 2006).

[24] Remarks of George H. Diacont, American Institute of Certified Public Accountants conference, Sec. Reg. & L. Rep. (BNA) (Nov. 20, 2006).

[25] Remarks of John White, director of the SEC's division of corporation finance, speaking at the Annual Securities Regulation Conference of the Practicing Law Institute, Corporate Accountability Report (BNA) (November 17, 2006).

[26] "Standing on Principles," CFO Magazine (September 1, 2006) quoting FASB chairman Robert Herz, available at *http://www.cfo.com/article.cfm/7852613/c_7850066.*

[27] Interim Report, supra note 34, at p. 80.

[28] "Treasury Secretary Urges Principles-Based Accounting and Internal Controls Reform," SEC Today (Nov. 27, 2006).

implementation of a "principles-based" accounting system will be "a long one."[29] As noted last year by Scott Taub, the SEC's former Interim Chief Accountant:

> Unfortunately, we have gotten to a place today where there is something of an aversion to applying judgment. Often, the answer people seek is whichever one is perceived to be the safest, but those answers are not always the most transparent for investors. And we constantly get calls for every potential interpretive matter to be documented and the answer officially blessed. This, of course, leads us further into complexity and rules-based accounting, places that most of us say we don't want to go.[30]

C. Securities Litigation Reform Proposals

1. Reforms Directed to Protection of Public Companies and Their Directors and Officers

a. The "Paulson Committee" Report

On November 30, 2006, the Committee on Capital Markets Regulation—colloquially referred to as the "Paulson Committee"—issued its "Interim Report of the Committee on Capital Markets Regulation" ("Report"), covering various aspects of the regulation of the capital markets, and proposing various regulatory and market reforms. Several of the reforms pertain to securities litigation and auditor liability. The latter subject is addressed in Section C(2)(a) below. As to securities litigation more generally, the Paulson Committee report notes that although the total number of class action suits has dropped in the last two years, the settlement values have sky-rocketed. The Report notes the threat that, as average settlement values climb, "so too do the incentives for companies to try to evade private litigation under the U.S. securities laws by simply choosing to sell their shares elsewhere." The Report recommends various reforms aimed at making the U.S. trading markets more attractive to companies, including:

- Resolving existing uncertainties in Rule 10b-5 liability, including issues of materiality, scienter and reliance.
- Preventing overlap between private suits and the SEC's "Fair Funds" compensation system for injured investors.
- Prohibiting so-called "pay to play" practices by class representatives, and discouraging the practice of the "lawyers hiring the client."

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[29] Remarks of SEC Chairman, Christopher Cox speaking at the SEC Historical Society Annual Meeting, Securities Regulation & Law Report (BNA) (June 12,2006).

[30] Remarks of SEC Acting Chief Accountant, Scott Taub, speaking at the SEC Historical Society Annual Meeting, (June 6, 2006).

- Eliminating enhanced criminal penalties against corporations who choose not to waive their attorney-client privilege, or decide to advance defense costs for officers and employees accused of criminal wrongdoing.

- Instituting greater protections for outside directors, including strengthening the ability of such directors to rely upon audited financial statements, and expanding the ability of outside directors to be indemnified against liability under Section 11 of the 1933 Act.

b. The Commission on Regulation of U.S. Capital Markets in the 21st Century

A March 2007 report from the Commission on the Regulation of U.S. Capital Markets in the 21st Century The Commission recommends several broad litigation reforms, and specifically calls upon the SEC to undertake a thorough review of how the Private Securities Litigation Reform Act has addressed the problem of frivolous shareholder litigation since its passage by Congress in 1995. Among the Commission's other recommendations:

- Eliminate public company quarterly earnings guidance; instead, companies would provide investors with "meaningful information on their long-term business strategies." Alternatively, companies could provide no more than annual guidance, expressed as a range of earnings, rather than earnings projections "to the penny."

- Prohibit the Department of Justice seeking privilege waivers from business organizations under threat of indictment or other enforcement action. As well, the DOJ should not be permitted to base charging decisions on whether a corporation advances counsel fees to its executives.

- Permit public companies to selectively waive their privileges, enabling them to produce documents to the SEC but still maintain a privilege as against private litigants.

- Restrict the scope of "scheme" liability under Section 10(b) (along the lines of the Charter Communications case currently before the U.S. Supreme Court).

- Allow a damages offset in private civil litigation for amounts paid by a company in settlement of an SEC action in the form of "Fair Funds."

c. The Bloomberg-Schumer Report

Also in early 2007, Mayor Michael R. Bloomberg of New York City and Senator Charles E. Schumer (D. New York) issued a comprehensive report entitled "Sustaining New York's and the US' Global Financial Services Leadership." The Bloomberg-Schumer Report made a number of recommendations to increase the competitiveness of the U.S. capital markets, a few of which are pertinent here. One key recommendation is to "implement securities litigation reform that has a significant short-term impact," which would include the following:

- Encourage SEC rulemaking to limit the liability of foreign companies with US listings to securities-related damages proportional to their degree of exposure to the US markets;

- Give smaller public companies the ability to "opt out" of some portions of Sarbanes-Oxley;

- Promote arbitration as a means of resolving securities-related disputes, using a charter amendment approved by shareholders;

- Legislatively limit punitive damages in securities cases; and

- Allow parties in federal securities class actions to appeal interlocutory judgments immediately to the courts of appeal.

d. The "Shadow Financial Regulatory Committee

On February 12, 2007, the "Shadow Financial Regulatory Committee issued a short statement on the competitiveness of the U.S. Securities markets, echoing many of the themes of the Paulson Committee report and the Bloomberg-Schumer report. The Shadow Financial Regulatory Committee is an organization comprised of a number of academicians sponsored by the American Enterprise Institute. In its report, the Committee expressed concern that "excessive regulation and large and arbitrary litigation risks appear to be hindering this country's ability to compete." Of all the risks facing the U.S. capital markets, the Committee chose to focus on only one—the litigation risk faced by public companies in the United States, and in particular the regressive economic profile of most securities class action litigation—where "one group of innocent shareholders is often required to pay another group of shareholders" for injuries that are "the responsibility of company managements." The Committee expressed the view that the deterrent value of class actions is small, and that the SEC's enforcement system "could do a better job of punishing wrongdoers and deterring financial manipulation and fraud at much less cost." The Committee recommends therefore that Congress adopt legislation that limits private securities class actions to those cases where insider trading had occurred, but otherwise require that violations of Rule 10b-5 be enforced against companies *only* by the SEC.

2. Reforms Directed to Protection of "Big Four" Accounting Firms

a. The "Paulson Committee" Report

The Paulson Committee Report includes several proposed reforms directed to the issue of auditor liability. The Report discussed the increasing liability risks posed to the remaining "Big Four" accounting firms, and the possible impairment of consumer choice if one of those firms were to fail. The Report noted in particular that there are more than three dozen cases involving tens of billions of dollars of potential exposure to accounting firms, and expressed the concern that even a relatively small share of proportional liability in these cases may lead to the financial failure of one of the remaining firms. "For the profession itself, there is consensus both inside

and out that the demise of one of the remaining Big Four could have adverse consequences for audited companies and their shareholders."[31]

In light of these concerns, the Report suggested several possible reforms:

- Create a safe harbor for certain defined auditing practices;
- Set a cap on auditor liability in certain circumstances;
- Grant regulators specific powers to appoint "monitors" to oversee operations of audit firms found to have engaged in systemic failures in process, management or personnel;
- Clarify and limit an auditor's duties under Section 10A; and
- Restrict criminal indictments against firms, as opposed to individual audit partners.

In light of the Committee recommendations, on May 17, 2007 the U.S. Treasury Department announced that it was appointed a Committee, headed up by former SEC Chairman Arthur Levitt and former SEC Chief Accountant Donald Nicolaisen, to consider possible reforms relating to the accounting profession. The group will examine the accounting industry in an effort to "address auditing industry concentration, and to consider options available to strengthen the industry's financial soundness and its ability to attract and retain qualified personnel."

As of the date of this paper, the near-term prognosis for the Report's recommendations with respect to auditor liability is unclear. But recent public remarks by the SEC's Chief Accountant, Conrad Hewitt, suggest that support for some form of liability reform for audit firms is building.[32] In similar remarks last year on the subject of liability protection for audit firms, Mr. Hewitt is reported to have said that "I definitely think it needs to be looked at."[33]

b. The Bloomberg-Schumer Report

The 2007 Bloomberg-Schumer Report makes one recommendation directed at the protection of audit firms, echoing the Paulson Committee report. Specifically, the Bloomberg-Schumer report proposes imposition of a "cap" on auditor damages that would maintain the deterrent effect of large financial penalties, while also reducing the likelihood of the highly concentrated US auditing industry losing another major player.

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[31] Interim Report of the Committee on Capital Markets Regulation ("Report"), p. 87. Relevant excerpts are attached as Exhibit B.

[32] Remarks of Chief Accountant Conrad Hewitt, SEC Speaks, February 9, 2007.

[33] "Concerned About Lawsuits Against Auditors, Top SEC Accountant Eyes Liability Safeguards" BNA Corporate Accountability, Vol. 4 No. 48 (December 15, 2006).

c. *Commission on Regulation of the U.S. Capital Markets in the 21st Century*

This Commission recommends that domestic and international policy makers "seriously consider proposals… to address the significant risks faced by the public audit profession from catastrophic litigation." The Commission includes representatives from stakeholders from the mutual fund and pension fund industries, as well as financial services firms, the insurance industry, and other important industry representatives. Among other findings, the report states that "sustaining a strong, economically viable, public company audit profession is vital to domestic and global capital markets," and that this condition is threatened by the current climate of civil litigation and regulatory proceedings against accounting firms.[34] Specific recommendations of the Commission include:

- Focus any criminal indictments on culpable individuals within audit firms, not the firms themselves;
- Create a national charter, similar to the national bank charter, that would confer positive benefits for audit firms by replacing the multiplicity of conflicting state regulations now facing audit firms;
- Include international audit firm liability issues as a topic to be addressed by the Group of Eight (G-8) countries;
- Expand the overall capacity of the audit profession through expansion of the next tier of audit firms below the Big Four; and
- Strengthen the ability of audit firms to use arbitration or other ADR solutions instead of litigation in the court system.

d. *European Commission Proposals*

The concept of liability "caps" also is being considered by the European Commission as a means of avoiding the failure of any of the major audit firms practicing in the EU. Among the ideas being considered by the European Commission are:

- Fixed monetary caps at the European level;
- Caps based on market capitalization of the audited company;
- Caps based upon a multiple of audit fees; and
- Proportionate liability based upon degree of responsibility.

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[34] Commission of the Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations (March 2007), available on the Commission website at www.CapitalMarketsCommission.com.

Charles McGreevy, an EU Internal Market commissioner, voices support for these ideas: "there is a real danger of one of the Big 4 being faced with a claim that could threaten its existence," he said.[35] The European Commission has established an "Auditors Liability Forum" to consider the issues, comprised of representatives from the Big Four firms, as well as other constituencies. In January 2007, the European Commissions issued a Staff Working Paper on "Auditors Liability and Its Impact on the European Capital Markets," in which it noted an array of potentially adverse consequences if another Big Four audit firm were to fail, and also the challenges to attracting new audit firms to step forward. The Commission's Working Paper was largely based upon an independent study by London Economics.[36]

III. DEBATE OVER THE PSLRA'S "STRONG INFERENCE" PLEADING STANDARD

In the past year, the issue of how high the Private Securities Litigation Reform Act of 1995 ("PSLRA") raised the standard for pleading scienter continued to be debated by the appellate courts. Under the PSLRA, a plaintiff alleging securities fraud must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Since the passage of the PSLRA, the majority of Circuits have held that the court must consider *all* reasonable inferences to be draw from the allegations, including inferences unfavorable to the plaintiffs.[37] This standard requires that an inference of scienter must be judged within the context of competing inferences and in many cases, must be more convincing than all competing inferences if it is to qualify as "strong" under the PSLRA. The majority of courts have continued to follow variations of this standard in the past year. The Seventh Circuit, however, pushed the minority view squarely into the spotlight with its decision in *Makor Issues & Rights, Ltd. v. Tellabs, Inc.,* 437 F.3d 588 (7th Cir. 2006), which prompted the Supreme Court to grant certiorari.[38] The Supreme Court's ruling is anticipated to settle the standard for pleading a "strong inference" under the PSLRA, and therefore *Tellabs* is the most important securities cases of the year with respect to pleading scienter.

A. The Role of "Inferences" At the Pleadings Stage: The *Tellabs* Decision

As this paper goes to press, one of the most important issues pertaining to the defense of securities class action litigation is awaiting decision by the United States Supreme Court. The issue is whether trial courts are required to accept only those "inferences" that the plaintiffs' lawyers allege in their complaints, or rather, whether the courts may consider all possible

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35 "EU Calls for Input on Auditor Liability Caps," Compliance Week (Feb. 6, 2007).

36 "EU Call for Opinions on Auditor Liability Caps," Compliance Week (April 2007)

37 *Gomper v. VISX, Inc.,* 298 F.3d 893 (9th Cir. 2002) (In order for an inference to be strong, it must be the most plausible inference); *Ezra Charitable Trust v. Tyco Int'l, LTD*, 466 F.3d 1 (1st Cir. 2006); *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2006); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) ("[T]he "strong inference" requirement means that plaintiffs are entitled only to the most plausible of competing inferences."); *Greeble v. FTP Software, Inc.*, 194 F.3d 185, 203 (1st Cir. 1999) ("there may be any number of legitimate reasons . . . Thus, it does not support a strong inference of scienter.").

38 The Supreme Court is expected to issue its opinion in June 2007.

inferences raised by the complaint, or through judicially noticeable facts. The Supreme Court recognized a distinct conflict among the Circuits on this issue, and granted certiorari in a case from the Seventh Circuit to resolve the question. The case was argued on March 28, 2007, and a decision is expected by the end of June 2007.

In 2006, the Seventh Circuit held in *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), that "[i]nstead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent."[39] The court reasoned that by allowing a judge to weigh competing inferences, would essentially allow the court to draw stronger inferences at the pleading stage than a jury would apply at trial, and therefore the weighing of competing inferences violated the Seventh Amendment. Applying this standard, the Seventh Circuit concluded that plaintiffs had adequately alleged "strong inference" of scienter in regards to a number of alleged misstatements made by Tellabs's CEO.[40]

Tellabs petitioned for certiorari to the United State Supreme Court, which was granted with the following question presented:

> Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a 'strong inference' that the defendant acted with scienter, as required under the Private Securities Litigation Reform Act of 1995.[41]

In their brief to the Supreme Court, Petitioners argued that determining the strength of an inference of scienter requires the court to consider the plausibility of the assertion in light of all the facts pled, including facts that undermine such an inference.[42] Further, Petitioners agued that it was the intent of Congress to reform the ordinary pleading standards in securities cases because of the economic realities associated with the expense of fighting meritless strike suits. *See id.* at 30. Congress therefore required "particularized facts" with respect to each act or omission alleged, as well facts giving rise to a *strong* inference of scienter.[43] In response, Respondents argued that (1) securities actions are subject to a "preponderance of the evidence" standard at summary judgment and at trial, and therefore the pleading standard should be consistent with the burden of proof;[44] (2) when enacting the PSLRA, Congress did not intend to abolish the principle that a plaintiff is entitled to have the complaint construed in its favor on a

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[39] *Id.* at 602

[40] *See id.* at 603.

[41] Brief of Petitioners at i, Tellabs, Inc. v. Makor Issues & Rights, Ltd., No. 06-484 (U.S. Feb. 9, 2007).

[42] *Id.* at 15.

[43] *See id.* at 24-25.

[44] Brief for Respondents at 15, *Tellabs*, No 06-484 (U.S. Mar. 9, 2007).

motion to dismiss,[45] and (3) interpreting the PSLRA to require a stronger inference than would be needed to support a jury's finding of scienter would violate the Constitution's jury trial guarantee.[46]

Several amicus briefs have been filed in connection with the *Tellabs* Supreme Court proceeding, most notably briefs filed on behalf of the SEC and the accounting industry in support of a heightened pleading standard. The accounting industry argued that to be "strong," an inference must be more than merely plausible or possible but rather free of significant doubt.[47] Under this standard, a plaintiff must plead facts from which a reasonable person would be convinced of the defendant's mental state.[48] The SEC also argued in support of Petitioners for a high standard, stating "[w]here the same facts simultaneously support both the conclusion that the defendant acted with scienter and the alternative conclusion [ ], the court should consider the relative strength of both inferences."[49] Further, if there is a substantial possibility that the defendant acted without scienter, then "the inference of scienter will not be 'strong.'" *Id.*

At the Supreme Court oral argument in March, several of the Justices expressed disagreement with the Seventh Circuit's standard. At one point, Justice Kennedy said, "I hope we're going to recognize that Congress thought it was doing something [when passing the PSLRA]," implying that Congress expressly sought to change the standard for pleading scienter when it passed the PSLRA.[50] When Justice Ginsburg and Justice Souter expressed concerns about preserving the traditional rule requiring that the complaint's allegations be read in the light most favorable to plaintiffs, counsel for Tellabs and counsel for the government responded that the PSLRA specifically intended to abolish the traditional rule, and a weighing of inferences could certainly not co-exist with the traditional rule, which would preclude consideration of competing inferences.[51]

In regards to the Seventh Amendment concerns, Justice Scalia suggested that a Seventh Amendment issue could be avoided if the pleading standard were viewed as an entry qualification, similar to the diversity requirement for federal jurisdiction.[52] Chief Justice Roberts posited that the Court may avoid any Seventh Amendment problem if the strong inference standard were applied both at the pleading stage and at trial, suggesting that he might be willing to consider a standard for liability higher than a preponderance of the evidence standard.[53]

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[45] *See id.*

[46] *Id.*

[47] Brief for the American Institute of Certified Public Accountants et al. as *Amici Curiae* in Support of Petitioners at 3, *Tellabs*, No. 06-484 (U.S. Feb. 9, 2007).

[48] *Id.*

[49] Brief for the United States as Amicus Curiae Supporting Petitioners at 9, *Tellabs*, No. 06-484 (U.S. Feb. 2007).

[50] Transcript of Oral Argument at 41, *Tellabs*, No. 06-484 (U.S. Mar. 28, 2007).

[51] *See id.* at 20-22.

[52] *See id.* at 30-31.

[53] *See id.* at 34.

An interesting precursor to the Court's upcoming ruling in *Tellabs* is the Supreme Court's recent opinion in *Bell Atlantic Corp. v. Twombly*, No. 05-1126, 530 U.S. __, 2007 U.S. LEXIS 5901 (May 21, 2007). In *Bell Atlantic*, a case regarding an antitrust conspiracy, the Court construed Federal Rule of Civil Procedure 8(a)(2)'s "short and plain statement" requirement. The Court rejected language from *Conley v. Gibson* suggesting that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove *no set of facts* in support of his claim which would entitle him to relief."[54] The Court held that the "no set of facts" language "has earned its retirement" and "is best forgotten as an incomplete, negative gloss on an accepted pleading standard: once a claim *has been stated adequately*, it may be supported by showing any set of facts consistent with the allegations in the complaint."[55] Under the proper standard, the Court held that a plaintiff must plead facts "plausibly suggesting (not merely consistent with)" unlawful conduct,[56] and dismissal is required where "nothing contained in the complaint invests either the action or inaction alleged with a plausible suggestion of [unlawfulness]."[57]

Bell Atlantic is careful not to impose a heightened pleading requirement for antitrust conspiracies, such as exists under Rule 9(b) for fraud, and the discussion is limited to the interpretation of Rule 8(a) of the Federal Rules. However, because of the heightened standard under the PSLRA, the existence of a heightened pleading standard in securities class actions arguably should lead to an even higher standard than imposed in *Bell Atlantic*.

B. Other Cases of Interest on Pleading Scienter

The First Circuit. In *Ezra Charitable Trust v. Tyco Int'l, LTD*, 466 F.3d 1, 6 (1st Cir. 2006), a case where plaintiffs alleged that Tyco's new management failed to fix the problems caused by the fraudulent conduct of Tyco's prior management, the First Circuit reaffirmed its flexible approach to assessing allegations of scienter. The court "eschewed any reliance on a rigid pleading formula, instead 'preferring to rely on a 'fact-specific approach' that proceeds case by case.'"[58] Further, the Court noted that all competing inferences must be considered in order to find a strong inference of scienter.[59] Applying this standard, the court found several facts that weakened an inference of scienter: (1) the defendants' attempts to warn investors of risks; (2) a short time period between an alleged misstatement and a later disclosure of inconsistent information; and (3) the fact that the disclosure of misconduct was done by new management concerning the conduct of prior management.[60] "Under all the facts and circumstances alleged, the second inference is at least as strong as the first and thus dooms plaintiffs' claims."[61] Thus,

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[54] 2007 U.S. LEXIS 5901, at *31.

[55] *Id.* at *35 (emphasis added).

[56] *Id.* at *25.

[57] *Id.* at *39.

[58] *Id.* at 6 (quoting *In re Cabletron Systems, Inc. Securities Litigation*, 311 F.3d 11, 38 (1st Cir. 2002)).

[59] *See Ezra*, 466 F.3d at 11.

[60] 466 F.3d at 9-11.

[61] *Id*. at 11.

the Court affirmed the district court's dismissal for failure to plead sufficiently to give rise to a strong inference of scienter.

With respect to motive and opportunity, the court held that, while motive and opportunity are relevant considerations, "'[c]atch-all allegations' which merely assert motive and opportunity, without something more, fail to satisfy the PSLRA."[62] Further, the *Ezra* court reaffirmed that mere violations of the Generally Accepted Accounting Principles ("GAAP") do not establish a "strong inference" of scienter in the First Circuit.[63]

The Third Circuit. In *Berckeley Inv. Group, Ltd. v. Colkitt*, 455 F.3d 195, 216 (3rd Cir. 2006), the Third Circuit continued to follow the standard set by the Second Circuit, requiring that a plaintiff "plead scienter by alleging facts 'establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior.'"[64] In affirming the district court's decision, the Third Circuit held that evidence that the defendant adhered to an industry custom does not rebut a showing of scienter noting that "[e]ven a universal industry practice may still be fraudulent."[65] Further, the court held that "the attorney-client privilege cannot be used as both a "shield" and a "sword," *i.e.*, the defendant cannot rely on legal advice to attack a scienter pleading while invoking attorney-client privilege to veil that advice from the plaintiff.[66]

The *Berckeley* Court also applied the established Third Circuit definition of recklessness, which is "an extreme departure from the standards of ordinary care" presenting "a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[67] This standard corresponds exactly to the "extreme recklessness" standard applied in the Fourth and Fifth Circuits.[68]

The Fourth Circuit. In *Teachers Ret. Syst. v. Hunter*, 477 F.3d 162, 184 (4th Cir. 2007, the Fourth Circuit continued to apply the "recklessness" standard as an alternative to a showing of intentional misconduct.[69] In affirming the district court's dismissal of the complaint for

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62 *Id.* at 10 (citing *Cabletron*, F.3d at 39).

63 *Ezra*, 466 F.3d at 12.

64 *Id.* (quoting *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3rd Circuit 1999), which in turn quoted *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 318 n.8 (3d Cir. 1997)).

65 *Id.* at 219.

66 *Id.* at 222.

67 *Id.* at 216 quoting *Advanta*, 180 F.3d at 353, which in turn quoted *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979)).

68 *See, e.g.*, *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343 (4th Cir. 2003) (quoting *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 621 (4th Cir. 1999); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 408 (5th Cir. 2001); *compare McNamara v. Pre-Paid Legal Servs.*, 189 Fed. Appx. 702, 710-11 (10th Cir. 2006); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1261 (10th Cir. 2001).

69 The Fourth Circuit rule is actually a "severe recklessness" standard. To establish a claim under 10-b-5, "a plaintiff must allege that the defendant made the misleading statement or omission intentionally or with "severe recklessness" regarding the danger of deceiving the plaintiff." *Id.* (citing *Ottmann v. Hanger Orthopedic*

[Footnote continued on next page]

failure to plead scienter with particularity, the *Teachers* court held that "to allege a securities fraud claim against individual defendants, a plaintiff must allege facts that support a 'strong inference' that each defendant acted with at least recklessness in making the false statement."[70] And when the defendant is a corporation, "the plaintiff must allege facts that support a strong inference of scienter with respect to at least one authorized agent of the corporation, since corporate liability derives from the actions of its agents.[71]

The Fourth Circuit agreed with the district court that plaintiffs' complaint "may have sufficiently alleged scienter through a series of attenuated inferences," however, because no misleading statements or omissions were sufficiently alleged, "any inferences that could be drawn from the facts are immaterial."[72]

In addition, the court held that "insider trading can imply scienter only if the timing and amount of a defendant's trading were 'unusual or suspicious[.]'"[73] Here, "[t]he complaint falls far short of showing that the trades were made at a time consistent with knowing or reckless fraud."

The Fifth Circuit. In *Fin. Acquisition Ptnrs. V. Blackwell*, 440 F.3d 278, 287 (5th Cir. 2006), the Fifth Circuit continued to allow plaintiffs to plead scienter under the PSLRA by showing either intentional misconduct or severe recklessness. "For PSLRA purposes, plaintiffs may establish scienter by demonstrating either intent *or severe recklessness*."[74] The Fifth Circuit held that the district court properly dismissed claims against individual defendants because plaintiffs' reliance on "general allegations and conclusory statements" failed adequately to plead scienter.[75] The Court rejected plaintiffs' attempt to establish scienter with allegations that the defendants were motivated by a desire to retain their jobs, holding that these types of allegations do "*not* satisfy the scienter requirement." [76]

The Sixth Circuit. In *Brown v. Earthboard Sports*, a financial advisor allegedly passed on inside information to a client, unaware that the information was false. *Brown*, 481 F.3d at 905. Both the advisor and his client bought stock on the basis of the tip, and both lost money as a result. *Id.* The district court granted summary judgment for the defendants finding the

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[Footnote continued from previous page]
Group, Inc., 353 F.3d 338, 343-44 (4th Cir. 2003). Despite stating this standard, *Teachers* appears to apply an "at least recklessness" standard with no explanation.

70 *Id.* (citing *Tellabs, Inc*., 437 F.3d at 602-03; *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc*., 365 F.3d 353, 363-67 (5th Cir. 2004)).

71 *Id.*

72 *Id.*

73 *Id.* (citing *In re PEC Solutions, Inc. Sec. Litig.*, 418 F.3d 379, 390 (4th Cir. 2005); *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001)).

74 *Id.* (citing Nathenson v. Zonagen, Inc., 267 F.3d 400, 408 (5th Cir. 2001)).

75 *Id.* at 289-90.

76 *Id.* (citing *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994) (holding scienter required for fraud claim not established merely by alleging defendants were motivated by job-retention goal).

plaintiffs failed to sufficiently plead scienter. The Sixth Circuit reversed, holding that that the advisor's ignorance of the scam did not bar a showing of scienter.[77] The Sixth Circuit applied a "totality of circumstances" test to determine if a set of facts established a "strong inference" of scienter.

> (1) insider trading at a suspicious time or in an unusual amount; (2) divergence between internal reports and external statements on the same subject; (3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information; (4) evidence of bribery by a top company official; (5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit; (6) disregard of the most current factual information before making statements; (7) disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication; (8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and (9) the self-interested motivation of defendants in the form of saving their salaries or jobs

481 F.3d at 917 (quoting *City of Monroe Employees Ret. Sys. v. Bridgestone Corp*., 399 F.3d 651, 683 (6th Cir. 2005)). The court further held that evidence that the defendant ignored warning signs, or "red flags," could strengthen an inference of scienter.[78]

The Seventh Circuit. *In Tricontinental Indus. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824, 841 (7th Cir. 2007), the Seventh Circuit affirmed the district court's dismissal of the complaint holding that a claim of scienter via an allegation of motive loses persuasiveness when the truth of the allegation itself is called into doubt by "a tenuous relationship between the alleged motivation for the inducement . . . and the action that [the company] was allegedly trying to induce." A tenuous relationship exists when "[the] theory of motive involves too many assumptions and too much speculation to support a *reasonable* inference . . . ." *Id.* at 842.

The Ninth Circuit. Over the last twelve months, the Ninth Circuit has upheld its pleading standard of "deliberate recklessness," although it has offered no additional discussion on the issue.[79] This relatively stringent standard eliminates "motive and opportunity" as a means of establishing scienter, as well as demanding that plaintiffs factually demonstrate a heightened degree of recklessness coming nearer to full intent than to mere recklessness. *See In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970, 979 (9th Cir. 1999).

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[77] *Id.* at 919 ("It is inherently reckless for a securities professional to attempt to violate the law, and it is no defense to suggest that he actually believed the tip to be true . . . .").

[78] Id. at 918 (citing *Diamonds, Inc. v. Chandler*, 364 F.3d 671, 686 (6th Cir. 2004).

[79] *See Betz v. Trainer Wortham & Co.*, 2007 U.S. App. Lexis 11114, at *7 (9th Cir. May 11, 2007); *see also Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006).

The Tenth Circuit. In *McNamara v. Pre-Paid Legal Servs.*, 189 Fed. Appx. 702, 710-11 (10th Cir. 2006) (unpublished), the court affirmed the district court's dismissal of the complaint for failure to plead scienter with particularity. The Tenth Circuit applied the interpretation of the PSLRA pleading standard that it had formulated in City *of Philadelphia v. Fleming Cos*., 264 F.3d 1245, 1257 (10th Cir. 2001). The *McNamara* court also followed *Fleming* in declining to create a rigid, categorical formula for assessing inferences of scienter. The *McNamara* court remarked that the excessive breadth and generality of the complaint damaged the persuasiveness of the plaintiff's case.[80] "This case may be a close call, but it is difficult to tell because the complaint is so rich in sweeping, generalized and sometimes conclusory allegations. Pleading precision could have . . . aided the critical analysis necessary to resolve a motion to dismiss."[81] While the district court had "cured" the complaint's over-breadth by simply paring down several allegations into one — shearing off potentially viable arguments in the process — the appellate court declined to do so.[82] It considered the allegations that the district court had disregarded, and, in doing so, it found the complaint more effective in establishing scienter than the district court had. *Id.* ("[C]haritably regarded, the complaint alleges more subtle means and purposes").

The Eleventh Circuit. In *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1264 (11th Cir. 2006), the Eleventh Circuit affirmed the district court's dismissal of the complaint for failure to sufficiently plead a strong inference of scienter. Following its previous holding in *Bryant v. Arvado Brands,*[83] the court applied the "severe recklessness" standard used in the Fourth and Fifth Circuits. The *Garfield* court held that the Sarbanes-Oxley act does not change the pleading standards of the PSLRA because an incorrect or erroneous Sarbanes-Oxley Act certification does not automatically establish scienter; it is still necessary to meet the Eleventh Circuit's standard of "severe recklessness."[84] This standard is met when the defendant ignores glaring red flags, none of which were evident in the facts of *Garfield*.[85] In reaching this decision, the *Garfield* court invoked two canons of statutory construction: (1) in the absence of language to the contrary, the words of a statute should be treated as having their plain, ordinary meaning, and (2) when two statutes can coexist without interfering with one another, the courts should allow them to do so without impeding either.[86]

C. "Group Pleading" of Scienter

Over the last twelve months, two appellate courts have addressed the issue of the "group pleading doctrine;" both have held that the doctrine is abolished under the PSLRA, meaning that

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80 *Id.* at 713.

81 *Id.*

82 *Id.*

83 *See* 187 F.3d 1271, 1287 (11th Cir. 2001); *see also Nathenson*, 267 F.3d at 407; *Ottman*, 353 F.3d at 343 (quoting *Phillips v. LCI*, 190 F.3d at 621).

84 *Id.* at 1266.

85 *Id.*

86 *See id.* at 1266.

against individual defendants, a plaintiff must allege facts that support a 'strong inference' that *each* defendant acted with [scienter] in making the false statement. If the defendant is a corporation, the plaintiff must allege facts that support a strong inference of scienter with respect to at least one authorized agent of the corporation, since corporate liability derives from the actions of its agents. See *Teachers' Ret. Sys.*, 477 F.3d at 184 (citations omitted); *Garfield*, 466 F.3d at 1264.

IV. THE SCOPE OF PRIMARY LIABILITY UNDER SECTION 10(b)

The other major securities case before the U.S. Supreme Court this year involves the scope of primary liability under Section 10(b) of the Exchange Act, and in particular whether certain participants in a fraudulent "scheme" can be deemed to have engaged in a "deceptive act" as defined by the statute. In light of the conflict among the Circuits on this issue, the Supreme Court granted certiorari in the *Charter Communications* case from the Eighth Circuit, and the case will be briefed and argued next term. Following is a summary of the issue, and a review of several major cases in addition to *Charter Communications* in which the issue of "scheme" liability has been addressed by the Courts of Appeal.

The pre-history of the *Charter Communications* case dates back to 1994, and the Supreme Court's watershed decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) In *Central Bank*, the Supreme Court held that Section 10(b) of the Securities Exchange Act of 1934 does not create civil liability for parties who merely aid and abet securities fraud violations.[87] This holding severely limited the availability of recovery under 10(b)-5 from "secondary actors" such as business partners, accountants, banks, and attorneys, who participated in securities fraud schemes. [88] *Central Bank* left the door open, however, by noting hat a person or entity still "may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met."[89] As a result, courts have struggled with the question as to what circumstances a securities fraud participant's conduct surpasses mere aiding and abetting and instead renders the party liable as a "primary violator under 10b-5." To be liable, primary violators must commit a manipulative or deceptive act.[90] Accordingly, cases addressing this issue involve a factual analysis of the alleged conduct with respect to the dividing line between secondary and primary liability under Section 10(b). The issue of reliance also has been a subject of court attention in the past year, with the courts

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[87] *Cent. Bank*, 511 U.S. at 177-78.

[88] Section 10(b) of the Securities Exchange Act of 1934 forbids the use or employment of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." SEC Rule 10b-5(a) specifically forbids employment of "any device, scheme, or artifice to defraud," while 10b-5(c) forbids any conduct or course of business which "would operate as a fraud or deceit upon any person in connection with the purchase or sale of security." Plaintiffs trying to recover damages from defendants under a "scheme liability" theory typically depend on these two subsections of the SEC rule.

[89] *Cent. Bank*, 511 U.S. at 191 (first emphasis added).

[90] *Id.* at 177-78 ("We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.").

differing on the issue of when it is appropriate to presume reliance on a secondary actor's conduct.

A. Manipulative or Deceptive Device or Contrivance: *Charter Communications*

1. Eighth Circuit – Adopting a Narrow Scope

In *In re Charter Communications, Inc.*, 443 F.3d 987 (8th Cir. 2006), *cert. granted sub nom. Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007), the court upheld the district court's dismissal of claims against vendors for their participation in transactions with Charter Communications, Inc. ("Charter") which were later used to inflate Charter's revenue reports. Specifically, Charter agreed to pay an additional $20 per unit to their vendors, in exchange for the vendors purchasing an equivalent amount of advertising from Charter. Charter capitalized the $20 increase in cost, while recording the ad sales as immediate revenue.[91] Plaintiffs argued that the Supreme Court's holding in *Central Bank* left the scope of primary liability under Rule 10b-5(a) and (c) undisturbed, and therefore the vendors' participation in this scheme amounted to a primary violation.

The Eighth Circuit rejected this interpretation, and instead held that "[t]he [Supreme] Court's categorical declaration that a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b),' included claims under Rule 10b-5(a) and (c)."[92] As a result, any successful allegation of "scheme liability" under Rule 10b-5(a) or (c) requires the use of a "manipulative or deceptive" act, as delineated in § 10(b) of the Securities Exchange Act.[93]

The Eighth Circuit interpreted the meaning of "deceptive" in § 10(b) to require "some misstatement or a failure to disclose by one who has a duty to disclose."[94] Accordingly, the court concluded that the vendors did not commit deceptive acts because under the facts alleged, neither vendor made misstatements which were relied upon by the investing public, nor were they under any duty to investors to disclose information regarding Charter's financial status.[95] The court ascribed a similarly narrow scope for the term "manipulative," calling it a "term of art" referring to "illegal trading practices such as 'wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.'"[96]

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[91] *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d at 989-90.

[92] *Id.* at 992 (quoting *Cent. Bank*, 511 U.S. at 173); *see also supra* note 2, discussing Rule 10b-5(a) and (c).

[93] *See also supra* note 6.

[94] *In re Charter Commc'ns, Inc.*, 443 F.3d at 992 (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-75 (2007)).

[95] *Id.*

[96] *Id.* at 990 (quoting *Santa Fe*, 430 U.S. at 476-77). The Eighth Circuit also noted that unlawful manipulation should be limited to "transactions in the [securities] marketplace, the effects of which were to prevent the market price from accurately reflecting the market's unimpeded judgment of the stock's value." *Id.* at 992 n.2 (quoting *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979)).

From these two definitions, the court held that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5."[97] The Supreme Court of the United States has granted a petition for writ of certiorari in this decision.[98]

2. Ninth Circuit – A More Liberal Rule

In contrast to the Eight Circuit's strict interpretation of § 10(b)'s requirement of a "manipulative or deceptive" act, the Ninth Circuit adopted a much broader and more malleable rule in *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006). Like *In re Charter Communications*, *Simpson* also involved an alleged "scheme" to inflate revenue reports. Specifically, it was alleged that "outside defendants" including AOL Time Warner ("AOL"), Cendant Corp. ("Cendant"), and L90, Inc. ("L90") participated in "triangular transactions," whereby Homestore.com ("Homestore") was able to record revenues from money that actually came from Homestore's own cash reserves.[99]

Plaintiffs alleged that Homestore "grossly overpaid" Cendant for a website which was considered to be a "bad asset." In exchange, Cendant recycled the excess payment back to Homestore by way of a separately created corporate entity, which entered into an agreement to purchase products and services from Homestore over the course of two years.[100] Homestore also entered into so-called "sham transactions" with other third party vendors, whereby the vendors would recycle money back to Homestore through AOL. That is, the third party vendors would use the Homestore money to purchase advertising from AOL, who would then furnish the money back to Homestore in a form similar to advertising commissions.[101] L90 entered into triangular transactions with Homestore that followed the same model as AOL,[102] the only difference being that an officer of AOL allegedly helped design the transactions in question.[103]

Relying on *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997), the Ninth Circuit began its analysis with the premise that "each defendant [must have] committed a manipulative or deceptive act in furtherance of the scheme."[104] From this premise, the Court concluded that the appropriate standard is whether or not the defendant "engaged in conduct that had the *principal purpose and effect* of creating a false appearance of fact in furtherance of the scheme."[105] By adopting this test for a "manipulative or deceptive act" the Ninth Circuit deliberately chose not to

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97 *In re Charter Commc'ns, Inc.*, 443 F.3d at 992.

98 *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007).

99 *Simpson*, 452 F.3d at 1043-44.

100 *Id.* at 1044-45.

101 *Id.* at 1044.

102 *Id.* at 1045.

103 *Id.* at 1045 n.1.

104 *Id.* at 1048 (quoting *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997)).

105 *Id.* at 1048 (emphasis added).

limit the scope of § 10(b) primary violators to those who make statements directly to the public, noting instead that § 10(b) prohibits the use of deceptive devices, whether directly or indirectly.[106] Distinguishing this type of scheme liability from aiding and abetting under *Central Bank*, the Ninth Circuit made clear that mere involvement in a transaction whose purpose is to deceive is insufficient to create liability. Rather, the defendant's *own conduct* within that scheme must have had a deceptive purpose and effect.[107]

The court provided in dicta examples of conduct that meets the "principle purpose and effect" test,[108] and conduct that falls short.[109] However, the court stated that as a general rule, "[c]onduct that is consistent with the defendants' normal course of business would not typically be considered to have the purpose and effect of creating a misrepresentation."[110]

In analyzing the specific allegations for each defendant, the court first observed that AOL's transactions had a legitimate business purpose because actual advertisements were purchased and sold.[111] The court went on to note that the transactions involving AOL did not create a false appearance until viewed in the context of Homestore's accounting practices, and thus AOL's own conduct within the scheme did not have the principal effect and purpose of creating a false appearance.[112] L90's transactions were not deceptive for similar reasons, bolstered by the fact that L90 did not help design the scheme in question.[113] Last, the court noted that although Cendant created a separate corporate entity for the transactions in question, there was no allegation that doing so created a false appearance of fact independent of Homestore's improper accounting.[114] Accordingly, the court affirmed the dismissal of charges against the defendants, but remanded to allow for the possibility of amendment.

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[106] *Id.* at 1049 (citing Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability under Section 10(b)*, 75 N.C. L. Rev. 691, 731 (1997)).

[107] *Id.* at 1048.

[108] *Id.* at 1049. Examples of "principle purpose and effect" conduct include defendants who were the primary architects of the scheme, *Quaak v. Dexia S.A.*, 357 F. Supp. 2d 330, 342 (D. Mass. 2005); auditors who "masterminded" the company's misleading accounting practices, *In re Global Crossing, Ltd. Sec. Litig.*, 332 F. Supp. 2d 319, 336-37 (S.D.N.Y. 2004); and outside business partners who created sham corporate entities specifically for misleading purposes, *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003).

[109] *Simpson*, 452 F.3d at 1050. Examples of conduct that does not have the "principle purpose and effect" of creating false appearances of fact include merely designing or entering a transaction knowing or intending that another party would misrepresent the transactions, *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 505 (S.D.N.Y. 2005); and conducting arms-length business transactions with a party that misrepresents to others, *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006).

[110] *Simpson*, 452 F.3d at 1050 (citing *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 580 (S.D. Tex. 2002)).

[111] *Id.* at 1053.

[112] *Id.* ("[AOL] may not be held liable for participating in legitimate transactions that became 'deceptive' only when distorted by the willful or intentional fraud of another party").

[113] *Id.* at 1054; *see also supra* note 24 discussing liability for being primary architects of a scheme.

[114] *Simpson*, 452 F.3d at 1054; *see also supra* note 24, discussing liability for creating sham corporate entities to mislead.

On remand, the district court late last year found that the allegations in the amended complaint were insufficient to sweep AOL or Cendant's conduct within the test outlined in *Simpson*.[115] The court found no allegation to support the conclusion that AOL's transactions were "either completely illegitimate or created a false appearance in themselves," and thus concluded that AOL could not have used a manipulative or deceptive device within the meaning of § 10(b).[116] The district court noted that AOL benefited substantially from the scheme supported the conclusion that AOL had a legitimate business interest in the transactions.[117] Similarly, the court found that "[no] new facts … indicate that Cendant's actions created a false appearance in themselves" and thus plaintiffs could not allege Cendant's use of a manipulative or deceptive device.[118] However, the district court observed that there was no evidence that L90's transactions had the same legitimacy as AOL's, because there was "no indication [in the complaint] that advertising products were or were not actually exchanged."[119] Thus, the district court allowed a second amended complaint to be filed with respect to L90.[120] The district court order is on appeal to the Ninth Circuit.[121]

3. Fifth Circuit – Falling in Line with the Eighth Circuit

In *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), the Fifth Circuit weighed in on the proper scope of the terms "manipulative" and "deceptive" with respect to scheme liability. In this appeal of the district court's order granting class certification in the *Enron* litigation, the Fifth Circuit reversed the district court's decision to certify a class, rejecting plaintiffs' central contention that the banks' participation in certain Enron transactions constituted a "deceptive act."[122]

Reaching the issue of the definition of "deception" under § 10(b), the Fifth Circuit sided with the Eighth Circuit's conclusion that "'deceptive' conduct involves either a misstatement or a failure to disclose by one who has a duty to disclose."[123] The court also found that while Enron certainly had a duty to its own shareholders, the banks did not share such a duty. Accordingly, the court concluded that the banks "at most aided and abetted Enron's deceit by making its misrepresentations more plausible. The banks' participation in the transactions … did not give rise to primary liability under § 10(b)."[124]

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115 *In re Homestore.com, Inc. Sec. Lit.*, No. CV-01-11115-RSWL, slip op. (C.D. Cal. Dec. 19, 2006).

116 *Id.* at 7.

117 *Id.* at 5.

118 *Id.* at 10.

119 *Id.* at 11.

120 *Id.* at 12.

121 *See CalSTRS v. Tafeen*, No. 07-55107 (9th Cir. Jan. 25, 2007).

122 *Regents of the Univ. of Cal.*, 482 F.3d at 377.

123 *Id.* at 388 (quoting *In re Charter Commc'ns*, 443 F.3d at 990). The court emphasized that when based on omissions rather than misrepresentations, "'deception' … requires that a defendant fail to satisfy a duty to disclose material information to a plaintiff." *Id.* at 384.

124 *Id.* at 390.

With respect to the to the term "manipulative," the Fifth Circuit also followed the Eighth Circuit in adopting the definition of "practices in the marketplace which have the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself."[125] Based on this definition, the court concluded that plaintiffs failed to allege any conduct that would constitute a manipulative device.[126] The court echoed the Eighth Circuit's concern that extending the scope of primary liability might bring "potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings."[127] The Fifth Circuit further observed that the effect of this uncertainty is especially severe in class actions, where "class certification is often practically dispositive of litigation like the case at bar."[128] Both courts concluded that "[d]ecisions of this magnitude should be made by Congress."[129]

B. Reliance or "Transaction Causation"

1. Ninth Circuit

In *Simpson v. AOL Time Warner, Inc.*,[130] the Ninth Circuit also addressed the question of when the element of reliance is satisfied, with regards to scheme liability defendants. In light of the Ninth Circuit's explicit statement that the "principle purpose and effect" test for deceptive conduct reached those who did not make statements directly to the public, the issue of reliance on defendant's conduct became crucial.[131]

The Ninth Circuit first observed that "[a] plaintiff may be presumed to have relied on a misrepresentation if the misleading or false information was injected into an efficient market."[132] However, in the case of scheme liability, defendants' conduct may not involve any misrepresentation or injection of false information into the market. Consistent with their "principle purpose and effect" standard for deceptive conduct, the court held that in such circumstances, "[t]he requirement of reliance is satisfied if the introduction of misleading statements into the securities market was the *intended end result* of a scheme to misrepresent revenue."[133] The court reasoned that "a scheme to defraud would not be complete until the fraudulent information was introduced to the market,"[134] and it is thus appropriate to presume,

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[125] *Id.* at 390-91 (quoting *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979) and adopting its definition in full). The Fifth Circuit read the Eighth Circuit opinion in *In re Charter Commc'ns* as having adopted this same view.

[126] *Regents of the Univ. of Cal.*, 482 F.3d at 392.

[127] *Id.* at 393 (quoting *In re Charter Commc'ns*, 443 F.3d at 992-93).

[128] *Id.*

[129] *Id.* (quoting *In re Charter Commc'ns*, 443 F.3d at 992-93).

[130] 452 F.3d 1040 (9th Cir. 2006). For a summary of the facts of this case, *see* Part II.A.2.

[131] *See supra* note 22 and accompanying text.

[132] *Simpson*, 452 F.3d at 1051. This is typically described as a "fraud-on-the-market" theory.

[133] *Id.* (emphasis added) (citing *In re ZZZZ Best Sec. Litig.*, 864 F.Supp. 960, 973 (C.D. Cal. 1994)).

[134] *Id.* (citing *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 509 (S.D.N.Y. 2005)).

"absent persuasive conflicting evidence," reliance on misstatements resulting from defendant's scheme.[135]

2. Fifth Circuit

The Fifth Circuit adopted a far more conservative approach than the Ninth on the issue of reliance. In *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*[136] the court considered the issue of scheme liability reliance in the context of class certification, under Federal Rule of Civil Procedure 23. In that case, plaintiff Enron shareholders alleged that the defendant banks entered into partnerships and transactions that allowed Enron to take liabilities off its books temporarily and to book revenue from the transactions when it was actually incurring debt.[137] Without a class-wide presumption of reliance, that element would have to be proven individually, defeating class certification.[138]

First, the court considered the availability of the *Affiliated Ute* presumption of reliance based on omission,[139] and concluded that the presumption requires that the defendant owe plaintiff a duty of disclosure.[140] Finding that the defendant banks were not fiduciaries and "owed no duty to plaintiffs other than the general duty … not to break the law,"[141] the court concluded that plaintiffs were unable to rely on a presumption of reliance for any omission to disclose the allegedly fraudulent activity.[142]

The court next considered the availability of a "fraud-on-the-market" presumption of reliance,[143] but concluded that the plaintiffs would have had to allege that "the defendant made public and material misrepresentations; i.e., the type of fraud on which an efficient market may be presumed to rely."[144] The court found that the banks' alleged actions were not "deceptive acts" or "manipulation" within the meaning of § 10(b) that could be considered public and material misrepresentations.[145] The court explained that "[p]resuming plaintiffs' allegations to

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[135] *Id.* at 1052 ("We may presume, absent persuasive conflicting evidence, that purchasers relied on misstatements produced by a defendant as part of a scheme to defraud, even if the defendant did not publish or release the misrepresentations directly to the securities market.").

[136] 482 F.3d 372 (5th Cir. 2007). For a summary of the facts of this case, *see* Part II.A.3.

[137] 482 F.3d at 377.

[138] *Regents of the Univ. of Cal.*, 482 F.3d at 383 ("[A] fraud class action cannot be certified when individual reliance will be an issue.") (citing *Castano v. Am. Tobacco*, 84 F.3d 734, 745 (5th Cir. 1996)).

[139] *See Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (presumptive reliance for improper omissions).

[140] *Regents of the Univ. of Cal.*, 482 F.3d at 384 (citing *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1119 (5th Cir. 1988)).

[141] *Id.* at 384-85.

[142] *Id.* at 384.

[143] *See Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (fraud-on-the-market theory of reliance under certain conditions).

[144] *Regents of the Univ. of Cal.*, 482 F.3d at 385-86.

[145] *See id.* at 390.

be true, Enron committed fraud by misstating its accounts, but the banks only aided and abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron's shareholders."[146] Because Section 10(b) does not give rise to aiding and abetting liability, the court held that plaintiffs could not rely on the fraud on the market hypothesis to invoke a presumption of reliance *against the bank defendants*.[147] In addition, the court held that, because the alleged activity took place outside the market for Enron securities, defendants had not engaged in market manipulation, and reliance could not be presumed under that alternative theory.[148]

The Fifth Circuit's strict construction of the prohibition on aiding and abetting liability under Section 10(b) effectively precludes the availability of the "fraud on the market" reliance presumption where there was no duty to disclose an alleged omission, and no direct manipulation of the market for a security by an alleged aider and abetter.[149]

C. Other Decisions of Interest

1. Second Circuit – Accountant's Duty to Correct

In *Overton v. Todman & Co., CPAs, P.C.*, 478 F.3d 479 (2d Cir. 2007), the Second Circuit explored a narrow subset of the "duty to disclose" required for deceptive omissions by the Fifth and Eighth Circuit. In *Overton,* the Court upheld a § 10(b) claim against accounting firm Todman & Co. ("Todman") for its failure to correct a past certified opinion. Todman had audited financial statements of Direct Brokerage, Inc. ("DBI") and issued a certified opinion regarding the company's financial status. In that opinion, defendant stated that DBI's financial statements fairly represented DBI's financial position "in conformity with U.S. generally accepted auditing principles."[150] At the time the defendant's opinion was issued, it allegedly contained significant errors which defendant had failed to uncover in its initial audit and subsequent annual audits. In light of the presence of certain "red flags",[151] plaintiffs alleged that the defendant was or should have been aware of the errors and DBI's precarious financial position, yet failed to withdraw its certification.[152] Shortly thereafter, DBI ceased operations as a result of its financial liabilities.[153]

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[146] *Id*. at 386.

[147] *Id*. at 390.

[148] *Id*.

[149] *Id*. at 392.

[150] *Overton*, 478 F.3d at 481.

[151] The specific "red flags" included (1) a large payroll tax requiring further analysis, which was never performed; (2) knowledge that DBI paid no payroll tax even though "plainly … payroll taxes were due"; (3) DBI's decrease in payroll taxes from approximately $250,000 to zero between 1998 and 1999; (4) DBI's precipitous decrease in payroll tax liabilities despite significant increase in employee compensation; and (5) failure to investigate this continuing trend. *Overton*, 478 F.3d at 481-82.

[152] *Id.* at 481-82.

[153] *Id.* at 482.

The district court dismissed plaintiff's claims against defendant accountant on the basis that "an accountant's failure to correct its certified opinion may support only aiding and abetting liability," which is not actionable under *Central Bank*.[154] The Second Circuit reversed, reaffirming its previous holding that an accountant has a "duty to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying."[155] Further, the Court held that a breach of that duty renders an accountant primarily liable under § 10(b) and Rule 10b-5 when the accountant:

> (1) makes a statement in its certified opinion that is false or misleading when made;
> (2) subsequently learns or was reckless in not learning that the earlier statement was false or misleading;
> (3) knows or should known that potential investors are relying on the opinion and financial statements; yet
> (4) fails to take reasonable steps to correct or withdraw its opinion and/or the financial statements; and
> (5) all the other requirements for liability are satisfied.[156]

The Court was careful, however, to qualify that its holding required an accountant to merely *correct* prior certified statements, not to update them.[157] The court distinguished correcting from updating by observing that a duty to correct merely requires the accountant to correct statements which were *false when made*, while a duty to update would require an accountant to correct statements which have become false or misleading due to intervening events.[158] The court specifically reserved the question of what circumstances might give rise to an accountant's duty to update,[159] and further limited its holding to require that an accountant correct "only those particular statements set forth in its opinion and/or the certified financial statements."[160]

2. D. C. Circuit – Investment Bank Lacked A Legal Duty

On May 8, 2007, the United States District Court for the District of Columbia issued a memorandum opinion in *In re Federal National Mortgage Ass'n*, No. MDL-1668, Consol. Civ. Action 04-1639, 2007 U.S. Dist. LEXIS 33939 (D.D.C. May 8, 2007), dismissing claims against

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154 *Id.* at 483.

155 *Id.* (quoting *Wright v. Ernst & Young LLP*, 152 F.3d 169, 177 (2d Cir. 1998)).

156 *Id.* at 486-87. For a list of "all the other requirements for liability," *see supra* note 6.

157 *Overton*, 478 F.3d at 487.

158 *Id.*

159 *Id.* at 488 (citing *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) for the proposition that "in limited circumstances, an issuer may have 'a duty to update…'" but reserving the issue of whether and when an accountant has a duty to update).

160 *Id.* The court provided an exception to this rule, where "the accountant exchanges his or her role for a role as an insider who vends the company's securities." *Id.* at 485, 488 (citing *Shapiro v. Cantor*, 123 F.3d 717, 721 (2d Cir. 1997)).

Goldman, Sachs & Co. for their involvement in two transactions with Fannie Mae. Plaintiffs alleged that Goldman Sachs designed and implemented two Real Estate Mortgage Investment Conduit ("REMIC") transactions, to be used as a "vehicle for issuing … securities that allows the issuer [Fannie Mae] to treat the transaction as a sale of assets for tax and accounting purposes."[161] The result of these transactions and securities sales was "to shift $107 million of Fannie Mae's earnings into future years."[162] In essence, plaintiffs alleged three specific aspects of Goldman Sachs's involvement in support of their theory of primary liability. First, Goldman Sachs proposed the two REMIC transactions in question.[163] Second, the ostensible purpose of the transactions was connected to Goldman Sachs's suggestion that they could "help Fannie Mae manage its income recognition for [generally accepted auditing principles] purposes."[164] Lastly, Goldman Sachs performed "unspecified functions as 'underwriter/dealer'" when the REMIC interests were being sold.[165]

The district court applied the standard for "manipulative or deceptive" adopted by the Fifth and Eighth Circuits,[166] and concluded that neither term correctly described Goldman Sachs's conduct since plaintiffs failed to allege reliance on any misstatement or omission by Goldman Sachs.[167] Further, the court noted that "the REMIC transactions … were not themselves unlawful, or inherently deceptive," and plaintiffs therefore could not rely upon scheme liability to recover from Goldman Sachs.[168] Accordingly, the district court dismissed the claims in question.

In a footnote, the district court took notice of the split between the Ninth Circuit on the one hand, and the Fifth and Eighth Circuits on the other. The court concluded that "the more restrictive interpretation of "deceptive acts" adopted by the Fifth and Eighth Circuits … is in better keeping with the Supreme Court's ruling in *Central Bank*," and rejected the Ninth Circuit's "more liberal standard."[169]

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[161] *In re Fed. Nat'l Mortgage Ass'n Sec., Derivative, and ERISA Litig.*, No. MDL-1668, Consol. Civ. Action 04-1639, 2007 U.S. Dist. LEXIS 33939, at *8-10 (D.D.C. May 8, 2007).

[162] *Id.* at *17.

[163] *Id.* at *16.

[164] *Id.* at *16, *17 n.2.

[165] *Id.* at *16.

[166] *Id.* at *20. *See also supra* notes 10, 12, 39, 41, and accompanying text; *infra* text accompanying note 69.

[167] *In re Fed. Nat'l Mortgage Ass'n Sec., Derivative, and ERISA Litig.,* No. MDL-1668, Consol. Civ. Action 04-1639, 2007 U.S. Dist. LEXIS 33939, at *23 (D.D.C. May 8, 2007). The court notes that Goldman Sachs was not involved in the preparation of Fannie Mae's allegedly misleading financial and public statements, nor was Goldman Sachs involved in Fannie Mae's improper accounting practices.

[168] *Id.* at *24 n.5. The court also cites a recent district court decision from the Southern District of Texas, finding that no scheme liability existed for a third party who designed an "innately deceptive" transaction. *Id.* at *24 n.5 (citing *In re Enron Corp. Sec., Derivative & ERISA Litig.*, No. MDL-1446, Civ. A. 01-3624, at 2006 U.S. Dist. LEXIS 88121, at *18 (S.D. Tex. Feb. 7, 2007)).

[169] *Id.* at *21 n.3.

V. CLASS CERTIFICATION IN FEDERAL SECURITIES LITIGATION

A. The Rule 23 Issue in Securities Class Actions

In the last year, the federal appellate courts have issued dramatically conflicting opinions addressing the way trial courts should treat class certification in securities and other complex cases. In these decisions, two issues in particular have received significant attention: the "merits" inquiry and the "fraud-on-the-market" doctrine.[170]

The underlying source of appellate court conflict is the evidentiary standard – and thereby the extent of inquiry into the merits of a case – necessary to satisfy class certification requirements. Two conflicting views on certification help to confuse litigators and district courts alike. An early – and largely outdated – view is that the certification decision should be made "as soon as practicable after the commencement of the action"[171] and should be "tailored to facts emerging in discovery." *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 2007 WL 1430225, No. 05-10791 at 11 (5th Cir. May 16, 2007). Accordingly, some courts have viewed certification as simply a brief stopping point on the way to litigation and as "divorced from the merits of the claim." *Id.* In contrast, the view that several Courts of Appeal now have adopted requires a more rigorous analysis of certification issues. This view recognizes the magnitude of the certification decision. Indeed, according to the Fifth Circuit, "class certification is often practically dispositive" of costly, high-stakes litigation.

These two opposing views and the lack of clear guidance from the Supreme Court have been troublesome for trial courts. In determining whether every Rule 23 requirement has been met, a district court must apply legal standards to a set of facts, some of which may be in dispute. Confusion arises when some requirement overlaps with an issue on the merits. When overlap occurs, the court must tread gingerly so as not to slip off the tight rope that separates it decisions from appellate review.[172] On one side is the district court's duty to find that every Rule 23 requirement has been fulfilled before certifying a class. On the other side is the proposition that a trial court has no authority to conduct an inquiry into the merits of a case at the class certification stage of litigation.

The fraud-on-the-market doctrine sometimes is invoked by plaintiffs to fulfill one of the Rule 23 requirements – predominance. This doctrine creates a rebutable presumption that, in an efficient market, "(1) misrepresentations by an issuer affect the price of securities traded in the open market, and (2) investors rely on the market price of securities as an accurate measure of their intrinsic value." *Hevesi v. Citigroup Inc.,* 366 F.3d 70, 77 (2d. Cir. 2004). Difficulties arise when the standard of proof for establishing the presumption – the same standard for fulfilling other Rule 23 requirements – is uncertain.

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[170] First articulated by the Supreme Court in *Basic v. Levinson*, 485 U.S. 224 (1988).

[171] The 2003 amendment to FED. R. CIV. P. 23(c)(1)(A) altered that language so that it now requires the decision "at an early practicable time."

[172] See FED. R. CIV. P. 23(f).

B. Circuit Split: The Extent of the "Merits" Inquiry When Evaluating Class Certification

Two Supreme Court cases in particular have created inter- and intra-circuit conflicts. In *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177 (1974), the Court stated: "We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action." But in *General Telephone Co. of the Southwest v. Falcon*, 457 U.S. 147, 160-161 (1982), the Court acknowledged that "actual, not presumed conformance with Rule 23(a) remains…indispensable" and that the certification ruling requires "rigorous analysis." Most circuit courts have interpreted *Eisen* narrowly and have found *Falcon* to allow – and indeed require – some inquiry into the merits of a case when they overlap with Rule 23 requirements. The Ninth Circuit arguably is the sole outlier, binding district courts to its unique and creative evidentiary standard.

1. The Second Circuit: In re IPO

The appeal in *In re Initial Public Offerings Securities Litigation*, 471 F.3d 24 (2d Cir. 2006), arose from the district court's certification of a consolidated class of investor-plaintiffs who alleged that defendants had engaged in a scheme of misrepresentations and market manipulations in violation of federal securities regulations. The standard for appellate review of class certification decisions is whether a trial court has abused its discretion. The Second Circuit found that this standard itself "implies that the district judge has some leeway as to [Rule 23] requirements." *Id*. at 40. But that leeway is not limitless: "to the extent that the ruling on a [Rule 23] requirement is supported by a finding of fact, that finding, like any other finding of fact, is reviewed under the 'clearly erroneous' standard." *Id*. at 41. That is, a ruling on a certification requirement "based on a finding of fact that is not clearly erroneous and with application of a [correct legal standard] could be affirmed as within allowable discretion…whether the ruling determined that the requirement was met or not met." *Id*. at 41. In considering the certification issue, the district judge has considerable discretion to limit both discovery and the extent of the hearing. Even so, the judge "must receive enough evidence…to be satisfied that each [Rule 23] requirement has been met." *Id*. at 41.

Applying this reasoning to the case at hand, the Second Circuit held that the district court erred in using a "some showing" standard of proof for meeting Rule 23 requirements. It also held as mistaken "the suggestion…that an expert's testimony may establish a component of a [certification] requirement simply by being not fatally flawed." *Id*. at 42.[173] The Court interpreted *Falcon*'s "rigorous analysis" language to apply with "equal force to all Rule 23 requirements," including those under Rule 23(b)(3). *In re IPO*, 471 F.3d at 33 n.3. And, it provided further guidance to district courts: "a district judge is to assess all of the relevant evidence admitted at the class certification stage and determine whether each [certification]

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[173] In disavowing the "some showing" standard, the Second Circuit abandoned two decisions that had been made prior to the 2003 amendments to RULE 23. See *In re Visa Check/MasterMoney Antitrust Litigation*, 280 F.3d 124 (2d. Cir. 2001), and *Caridad v. Metro-North Commuter Railroad*, 191 F. 3d 283 (2d. Cir. 1999).

requirement has been met, just as the judge would resolve a dispute about any other threshold prerequisite for continuing a lawsuit."[174] *Id.*

The Second Circuit then examined *Eisen* and decided that the often-quoted statement that trial courts may not inquire into the merits of a case at the certification stage was "made in a case in which the district court's merits inquiry had nothing to do with determining the requirements for class certification." 471 F.3d at 33. In other words, the language in *Eisen* applies only to a merits inquiry at the certification stage that is unrelated to a determination of Rule 23 requirements. Therefore, according to the Second Circuit, *Eisen* does not preclude district courts from inquiring into the merits when they overlap with the Rule 23 requirements. Taken together with its interpretation of the proper standard of proof, this holding demands that trial courts use rigorous analysis when making determinations on certification requirements, even when such analysis compels inquiry into the merits of a case.

The Second Circuit vacated the district court's orders granting class certification to the plaintiffs and remanded the case to the district court for further proceedings. Recently, the Second Circuit also denied the plaintiffs' petition for rehearing en banc. *In re Initial Public Offerings Securities Litigation*, 483 F.3d 70 (2d Cir. 2007). This denial may set the stage for the Supreme Court to take up an issue that is the subject of an increasingly apparent circuit split, but Supreme Court action may also depend in part on whether the Ninth Circuit denies Walmart's petition for a rehearing en banc in *Dukes v. Wal-Mart Stores, Inc.*, 474 F.3d 1214 (9th Cir. 2007).[175]

2. The Fifth Circuit: *Regents* and *Oscar*

Like the Second Circuit, the Fifth Circuit has disavowed the view that the certification inquiry is always divorced from any inquiry into the merits of a case.

The district court in *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), INC.*, 482 F.3d 372 (5th Cir. 2007) -- a securities suit based on scheme liability -- granted plaintiffs' motion for class certification. In doing so, it allowed plaintiffs to invoke the fraud-on-the-market presumption to fulfill the predominance requirement of Rule 23(b)(3). The Fifth Circuit reversed and remanded, holding that the district court misapplied the fraud-on-the-market presumption. *See discussion infra* Part III.

In reversing class certification, the Court did not set forth a clear standard for trial courts. Instead it noted that the relevance of an issue to both class certification and the merits does not bar review of that issue under Rule 23(f):

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[174] Although the Court mentions the "standards we have today set forth" several times throughout the remainder of the opinion, it does not clarify or rearticulate its new standard. Thus, it seems that the Second Circuit will hold district courts to this language regarding threshold issues as well as the language of *Falcon* calling for "rigorous analysis."

[175] *See infra* Section IV(D)(3), for a discussion of *Dukes*.

> The necessity of establishing a class-wide presumption of reliance in securities class actions makes substantial merits review on a [Rule 23(f)] appeal inevitable. A class-wide presumption of reliance is not only crucial to class certification, it *prima facie* establishes a critical element of the substantive tort… [And] legally appropriate examination makes interlocutory appeals in securities cases practically dispositive of the merits.

Regents, 482 F.3d at 393. And, instead of clearly and articulately spelling out its new standard, it simply applied it, delving into the weaknesses of the plaintiffs' theory of liability and rejecting the certification decision. Thus, readers themselves are left to discern a formulated rule from the Court's analysis.

A petition for certiorari has been filed with the Supreme Court in the *Regents* case. *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), INC.*, 482 F.3d 372 (5th Cir. 2007), *petition for cert. filed* (U.S. Apr. 5, 2007) (No.06-1341). Some commentators argue that the Supreme Court should grant cert in the *Regents* case and hear it along with *In re Charter Communications, Inc.*, an Eighth Circuit case dealing with the validity of scheme liability and in which the Supreme Court recently granted cert. *In re Charter Communications,* 443 F.3d 987 (8th Cir. 2006), *cert. granted sub nom. Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007).[176] In hearing the *Regents* case, these commentators argue, the Supreme Court should take the opportunity to resolve the circuit split on the issue of class certification.

The Fifth Circuit further developed its standard for trial court certification decisions in its very recent decision in *Oscar*. In *Oscar*, the Court once again faced the question of whether the district court's certification properly relied upon the fraud-on-the-market doctrine. *Oscar*, WL 1430225 at 5. In holding that the fraud-on-the-market presumption of reliance was not appropriate in this case, the two judge majority noted that "district courts often tread too lightly on [Rule 23] requirements that overlap with the 10b-5 merits, out of a mistaken belief that merits questions may never be addressed at the class certification stage." *Id*. at 14. The majority took this opportunity to endorse the Second Circuit's fact-specific interpretation of *Eisen*. It went on to hold that "loss causation [satisfying the predominance requirement] must be established at the class certification stage by a preponderance of all admissible evidence."[177] The majority thereby set forth a preponderance of admissible evidence standard to guide trial court inquiries.[178]

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[176] *See supra* pp. 22-23, for a discussion of *In re Charter Communications* and scheme liability generally.

[177] The Court added that this decision does not preclude reexamination of loss causation as an element of a 10b-5 claim at summary judgment. *See Oscar,* WL 1430225 at 5 n.40. Similarly, the Second Circuit also noted that "the trier of fact, whether a juror or the district court judge, is not bound by the factual determinations made at the class certification stage when ruling on the merits." *In re IPO*, 471 F.3d at 41.

[178] In his dissenting opinion, Judge Dennis argued that the court must "restrict [its] review of the merits to encompass only those issues necessary to determining whether the proposed class satisfies the requirements of Rule 23." *Oscar*, WL 1430225 at 16. Proof of loss causation, argued Judge Dennis, should not be made "a prerequisite to the establishment of reliance through the fraud-on-the-market presumption for purposes of certification…." and "will not, in the ordinary case, be otherwise relevant to the district court's Rule 23

[Footnote continued on next page]

3. The Ninth Circuit: *Dukes*

Although not a securities case, the Ninth Circuit's decision in *Dukes v. Wal-Mart Stores, Inc.*, 474 F.3d 1214 (9th Cir. 2007), plainly conflicts with the class certification decisions of other circuit courts. *Dukes* involved a Title VII action alleging Wal-Mart was responsible for sex discrimination against its employees. The district court granted class certification for the proposed class – all of whom were current and former female employees of Wal-Mart. Wal-Mart appealed. The Ninth Circuit upheld the lower court's decision, thereby establishing a lenient standard for district court review of plaintiffs' certification evidence.

The Ninth Circuit first noted that the "party seeking certification bears the burden of showing" that it has met all the requirements of Rule 23. *Dukes*, 474 F.3d at 1224. It then engaged in an extensive analysis of each requirement. In addressing each individual requirement, the Court consistently deferred to plaintiffs' evidence and the district court's discretion, and rejected defendant's challenges.

For example, when Wal-Mart challenged the testimony of an expert witness that, it contended, did not pass scrutiny under *Daubert*, the court dismissed the objection by announcing a new evidentiary standard: "[trial] courts need not apply the full *Daubert* 'gate-keeper' standard at the class certification stage. Rather, 'a lower *Daubert* standard should be employed at this stage of the proceedings.'" *Id.* at 1227.[179] It cited *Eisen* for support of its deferential standard, saying "the district court was on very solid ground here as it has long been recognized that arguments evaluating the weight of evidence or the merits of a case are improper at the class certification stage." *Dukes*, 474 F.3d at 1227. The Court went on to announce that its job on appeal "is to resolve whether the 'evidence is sufficient to demonstrate common questions of fact warranting certification of the proposed class, not whether the evidence ultimately will be persuasive' to the trier of fact." *Id.* at 1229.[180] Thus, while other circuits espouse "rigorous analysis" or the "preponderance of the evidence" standards, it seems that the Ninth Circuit holds district courts to a less demanding "sufficiency of evidence" standard. *See* discussion *supra* Parts II.A., II.B.

This view conflicts with the approach to class certification taken by other Courts of Appeal. Throughout its opinion, the Ninth Circuit cited the Second Circuit decisions *In re Visa Check* and *Caridad*. But it failed to acknowledge *In re IPO*, where the Second Circuit expressly repudiated those decisions. It also declined to consider any alternative interpretations of *Eisen,* as articulated by the Second and Fifth Circuits.

[Footnote continued from previous page]

inquiry." *Oscar*, WL 1430225 at 15-16. Therefore, by requiring proof of loss causation, "the majority's decision dramatically expands the scope of class certification review…to effectively require a mini-trial on the merits of plaintiffs' claims at the certification stage" and thus creates a conflict with the decisions of other circuits, including the Second Circuit's decision in *In re Initial Public Offerings Securities Litigation*. *Id.*

[179] The Court quoted Thomas & Thomas Rodmakers, Inc. v. Newport Adhesives & Composites, Inc., 209 F.R.D. 159, 162 (C.D.Cal. 2002) See also In re Visa Check, 280 F.3d at 132 n.4.

[180] (quoting *In re Visa Check,* 280 F.3d at 135)(see also *Caridad*, 191 F.3d at 292-293 (noting that a district court may not weigh conflicting expert evidence or engage in "statistical dueling" of experts)).

The panel's restrictive standard of inquiry also appears to conflict with prior Ninth Circuit decisions in the securities arena. In its opinion in *Blackie v. Barrack,* 524 F.2d 891, 897 (9th Cir. 1975), the Ninth Circuit asserted that "unlike…the notice issue in *Eisen*," determinations relevant to certification criteria "may require review of the same facts and the same law presented by review of the merits." It restated this formulation in *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 509 (9th Cir. 1992), saying that trial courts are "at liberty to consider evidence which goes to the requirements of Rule 23 even though the evidence may also relate to the underlying merits of the case."[181] In light of this intra-circuit conflict, Wal-Mart has filed a petition for rehearing en banc which is still pending before the Ninth Circuit.[182] If the Ninth Circuit denies the petition, both the Second Circuit and Ninth Circuit will have denied petitions to rehear cases that offer dramatically conflicting approaches to the way trial courts should treat class certification, making it more likely for the Supreme Court to take up the issue.

C. The Fraud-on-the-Market Doctrine in Class Certification

The fraud-on-the-market doctrine "permits a trial court to presume that each class member has satisfied the reliance element of their 10b-5 claim [under certain circumstances]. Without this presumption, questions of individual reliance would predominate, and the proposed class would fail." *Oscar*, WL 1430225 at 5-6. The doctrine as articulated in *Basic* allows for each circuit to develop its own fraud-on-the-market rules. *Id.* at 6. First, the Second and Fifth Circuits have applied their newly announced Rule 23 standards to of the *Basic* presumption.

1. The First Circuit Weighs In On Market Efficiency

In *In re Polymedica Corp. Sec. Litig.*, 432 F.3d 1, 10 (1st Cir. 2005), the First Circuit reaffirmed that, following *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), a demonstration of market efficiency for purposes of relying on the fraud-on-the market presumption of reliance obviates the requirement that a plaintiff demonstrate individual reliance on a defendant's alleged material misstatement or omission. However, the *Polymedica* court rejected the district court's standard for market efficiency and held that, in an efficient market, the market price "fully reflects" all publicly available information. *In re Polymedica Corp. Sec. Litig.*, 432 F.3d 1, 14 (1st Cir. 2005). It held that an efficient market is one in which information disclosed to the market is "immediately" or "rapidly" incorporated into the stock price so that average investors are unable to profit from the disclosure of new information regarding stocks. *Id.* at 19. On that basis, it vacated the district court's grant of class certification. *Id*. On remand, the district court considered the question of what "immediate" or "rapid" absorption of information means in practice, stating:

> The First Circuit's definition and relevant explanation of efficiency in *Polymedica*, which stated that the stock price must quickly and fully reflect the release of public information such that ordinary investors cannot profitably trade

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[181] *See* Wal-Mart's Pet. for Reh'g En Banc, Feb. 20, 2007.
[182] *See Id.*

> on the basis of it, requires that the reaction to news be fully completed on the same trading day as its release – and perhaps even within hours or minutes.

In re Polymedica Corp. Sec. Litig., 453 F. Supp. 2d 260, 278 (D. Mass. 2006). The court further noted that the reaction should be completed on "the next trading day, if the news is released after the market has closed." *Id*. at n.22.

2. The Second Circuit Inquires into Market Efficiency

In the Second Circuit, establishment of an efficient market is a prerequisite to application of the *Basic* presumption. In *In re IPO*, the contested market was a primary market for newly issued securities. The Court concluded that in an IPO, there is no "well developed and efficient market in offered securities," and in addition, plaintiffs' allegations of "widespread knowledge of the scheme indicated the very antithesis of an efficient market." *In re IPO*, 471 F.3d at 42-43. In other words, plaintiffs' evidence failed to demonstrate the existence of an efficient market. Therefore, the Court held, under the rigorous standard explicated earlier in the opinion, that plaintiffs did not satisfy the Rule 23 requirement of predominance of common questions over individual questions. *Id.* at 42.

3. The Fifth Circuit Refines Its Analysis of Market Efficiency

In the Fifth Circuit, plaintiffs are required to establish loss causation in order to take advantage of the reliance presumption.[183] That is, plaintiffs must "prove that the defendant's non-disclosure materially affected the market price of the security." *Id.* at 7.[184] Given this rule, the question becomes twofold: should fraud-on-the-market indicators be analyzed at the class certification stage, and if so, what is the appropriate extent of the district court's inquiry into those issues? *Id.* at 10-16. The Court struggled with these questions in *Regents*, though it eventually held that plaintiffs failed to show common issues of loss causation and therefore did not trigger the fraud-on-the-market presumption. Even so, it managed to avoid proclaiming one definitive and broadly applicable standard for certification treatment of the fraud-on-the-market presumption.

In *Oscar*, however, the Fifth Circuit used *Regents* as a starting point and from there was able to provide district courts with much more comprehensible guidance. First, the majority held it proper for district courts to address loss causation at the class certification stage. In doing so, it recognized the extraordinary power that both the fraud-on-the-market doctrine and the class certification decision, generally, have come to wield: "we cannot ignore the *in terrorem* power of certification, continuing to abide the practice of withholding until 'trial' a merit inquiry central to

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[183] Loss causation is a prerequisite to the fraud-on-the-market presumption. As articulated in *Greenburg,* reliance is presumed if the plaintiffs can show that (1) the defendant made public material misrepresentations, (2) the defendant's shares were traded in an efficient market, and (3) the plaintiffs traded shares between the time the misrepresentations were made and the time the truth was revealed. *Greenburg v. Crossroads Systems, Inc.*, 364 F.3d 657, 661 (5th Cir. 2004).

[184] The Court also noted that its approach is not affected by the Supreme Court's decision in *Dura Pharmaceuticals., Inc. v. Broudo,* 544 U.S. 336 (2005).

the certification decision, and failing to insist upon a greater showing of loss causation to sustain certification." *Oscar*, WL 1430225 at 12. But the majority found firm support for its conclusions in the amended text of Rule 23(c)(1)(A), reasoning that the legislature already had weighed in on the issue. It also found support in internal and external precedent. In a similar securities case, *Unger v. Amedisys Inc.*, 401 F.3d 316 (5th Cir. 2005), the majority held that "the plain text of Rule 23 requires the court to 'find,' not merely assume, the facts favoring class certification…[and concluded that] Rule 23 mandates a complete analysis of fraud-on-the-market indicators" and therefore requires district courts to "address and weigh factors both for and against market efficiency." *Oscar,* WL 1430225 at 13-14 (quoting *Unger*, 401 F.3d at 321, 325).

The Fifth Circuit also addressed the proper evidentiary standard, requiring loss causation to be established at the certification stage by "a preponderance of all admissible evidence." Applying this standard to the case at hand, the majority found the plaintiffs' assumption "that every material misrepresentation will move a stock in an efficient market" was unsupported by the evidence. Thus, the majority identified the district court's legal error in applying an improper standard to the inquiry. And, furthermore, it concluded that the district court's factual conclusions as to causation were untenable, and therefore, class certification was an abuse of its discretion.

VI. RECENT SECURITIES LITIGATION DECISIONS ON LOSS CAUSATION

Since the landmark decision two years ago in *Dura Pharmaceuticals, Inc. v. Broudo*,[185] the federal courts have struggled to apply the Supreme Court's ruling on how loss causation must be pled in class actions under the Private Securities Litigation Reform Act. The good news appears to be that the majority of appellate decisions that have applied *Dura* have held that the standard for pleading loss causation requires pleading with particularity a direct relationship between a company's stock price decline and the public disclosure of prior fraudulent conduct. That said, the Supreme Court's guidance in *Dura* leaves a number of open questions about how loss causation may apply to fact patterns where, for example, adverse information is "leaked" to the marketplace, and other circumstances that do not involve the proto-typical stock drop scenario.

A. The Teachings of *Dura*

The *Dura* decision is one of the rare Supreme Court decisions on the securities laws in the last several decades. In *Dura,* certiorari was granted to resolve the clear circuit split on the pleading standards for loss causation, and the obvious flaws with the Ninth Circuit's approach.

Dura was, of course, a pleading case, but its holdings also apply to the issue of *proving* loss causation. The Court's decision basically addressed the issue of whether the mere pleading of price inflation at the time of purchase of a security, combined with allegations that the fraud "touched upon" the reasons for the subsequent loss, were sufficient under the securities laws.

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[185] 544 U.S. 336 (2005).

The Supreme Court emphatically said "no," and provided critical guidance on how stock price must be considered in evaluating the sufficiency of pleading of "loss."

The Court's express holdings were largely, but not entirely, favorable to defendants. *First,* the Court held that price inflation at the time of purchase and subsequent elimination of price inflation in a manner "touching upon" fraud is not sufficient to allege or prove loss causation. This was the biggest "win," perhaps, in the Court's overall opinion. *Second,* the Court held that *fraud* must cause the loss, *i.e.*, proximately cause a subsequent decline in stock price.

Third, and disappointingly, the Court did not adopt explicitly the rule urged by defendants, requiring the pleading of the "curative" disclosure of the fraud at the end of the class period and the facts demonstrating how that disclosure caused a material price decline. The Court suggested that fraud may "leak out" and cause loss over time. The Court also side-stepped the issue of whether "loss" can occur even where the stock price at the time of sale is higher than at the time of purchase.

Fourth, the Court applied Federal Rule of Civil Procedure 8(a), to the issue of loss standard, without deciding whether Rule 8(a) *always* applies, or whether Rule 9(b)'s heightened pleading standard might apply to loss causation in the event that the claim is grounded in fraud. As we shall see below, the lower courts have struggled with this issue in a number of cases subsequent to *Dura*.

Finally, the Court simply did not address the application of loss causation principles in cases involving alleged "scheme" liability—an issue that now is being confronted in several high profile cases around the country.

B. *Dura* on Remand

Following the Supreme Court decision remanding the case, the Northern District of California denied, in part, the defendants' motion to dismiss, in a decision that should be dubbed "*Dura II*."[186] On remand, the plaintiffs alleged fraud based on the failure to disclose problems with clinical trials of Dura's key asthma drug. The end-of-class period disclosure in February 1998, which led to a 47 per cent stock price drop, did *not* address problems with the asthma drug, and that disclosure was found insufficient to plead loss causation.

But plaintiffs did not stop there. Instead, they contended that although the class was comprised of only purchasers before February 24, 1998, those purchasers still could base their loss on disclosures occurring many months after the end of the class period. Plaintiffs contended that causation of loss occurred in September, November, and December 1998—well after the end of the class period—when negative disclosures concerning the asthma drug led to additional price declines. The District Court recognized the anomaly of cutting off the class period at February 1998, but found no legal prohibition against this. The District Court also rejected

[186] 2006 U.S. Dist. LEXIS 41193 (S.D. Cal. 2006).

defendants' argument that the effect of this was to improperly expand the class period *sub silentio*, and that claims based upon post-class period losses were barred by the statute of limitations. The District Court held that the "loss" involved the same claims of misrepresentations made by the same plaintiffs. In so holding, the District Court clearly ignored the necessary implication of the Supreme Court opinion that no claim exists unless loss is caused, and this particular claim was brought well past the applicable limitations period. The District Court observed that the Supreme Court could have held that no claim was valid since the alleged curative disclosures occurred months after the end of the class period, but it did not.[187]

C. Key 2006-07 Decisions Applying *Dura*

Since the Supreme Court decision, there have been well over 400 reported cases citing *Dura*, but only a relative handful of appellate cases citing and applying *Dura.* Following is a run-down of the key decisions, from both the district and circuit courts, handed down during the period January 2006 to May 2007.

1. First Circuit

In the First Circuit several cases in the district courts relating to loss causation have been decided. *In Brumbaugh v. Wave Sys. Corp.*, 416 F. Supp. 2d 239 (D. Mass. 2006), the court, in ruling on defendants' motion to dismiss, found plaintiffs' allegations sufficient to plead loss causation. *See id*. at 256. Plaintiffs claimed that the defendants (Wave Systems Corporation ("Wave" and its officers) inflated Wave's stock price by failing to disclose material information about the character and extent of a relationship with Intel and by making misrepresentations regarding how the Intel relationship would fulfill Wave's earlier predictions about revenue growth. *Id.* at 255-56. The plaintiffs also alleged that news of an SEC investigation relating to these misleading statements sent shares down 17.13% the following day. *See id.* at 245, 256. Defendants argued that Wave's disclosure of the SEC investigation was not an admission that the earlier statements were themselves misleading. *Id.* at 256. The court cited *Dura* for the proposition that a corrective disclosure need not precede a stock's decline. *Id.*[188] The court found that the complaint contained "the very allegations regarding share price decrease and public exposure to the truth the Supreme Court found lacking in the *Dura* complaint." *Id*. at 256.[189]

In *Quaak v. Dexia, S.A.*, 445 F. Supp. 2d 130 (D. Mass. 2006), plaintiff investors filed suit against Dexia Bank Belgium ("Dexia"), a successor to Artesia Banking Corp., S.A. ("Artesia"), whose wholly owned subsidiary, Artesia Securities, had issued "buy" recommendations on a company that was a customer of Artesia and in which Artesia owned

[187] After the district court issued this ruling, plaintiffs further amended the complaint, in response to which defendants filed a further motion to dismiss that is still pending as of the date of publication of this article.

[188] Citing *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 1631, 32 (2005) (discussing the implications of stock's initial inflation before the relevant truth begins to leak out and after the truth makes its way into the market place).

[189] Citing *In re Immune Response Secs. Litig.,* 375 F. Supp. 2d 983, 1025 (S.D. Cal. 2005).

stock, despite the defendants' alleged knowledge that the company was in financial difficulty. Plaintiffs' complaint was based specifically on a series of analyst reports issued by Artesia Securities that encouraged readers to purchase stock on the basis of false financial data. Dexia argued that plaintiffs inadequately pled loss causation by failing to demonstrate a link between these analyst reports and their economic loss, since stock prices did not always increase following these reports but occasionally actually declined on the day these reports were issued. *Id.* at 142. With little analysis, the court denied Dexia's motion to dismiss finding, in part, that plaintiffs had adequately pled loss causation where they alleged that (i) the analyst reports caused them to buy company stock at inflated prices, and (ii) the revelation of the company's true situation led to a decline in the stock price, causing the plaintiffs' damages. *Id.* at 142-143. The court held, therefore, that the plaintiffs had adequately alleged that the misrepresentations and omissions had caused them to buy the stock at an inflated price, and the loss that they suffered when the truth was revealed. *Id.* at 143.

In another case involving third-party analysts, *In re Credit Suisse-AOL Securities Litigation,* 465 F. Supp. 2d 34 (D. Mass. 2006), the district court came to a different conclusion. In that case, class action plaintiff-investors who had purchased stock in AOL Time Warner, Inc., ("AOL") between January 12, 2001, and July 24, 2002, brought suit against defendants, including, Credit Suisse First Boston (USA), Inc. ("CSFB"), claiming that defendants issued thirty-five research reports encouraging investors to purchase AOL stock while intentionally withholding their beliefs and information as to AOL's precarious financial condition from the public. *Id.* at 37. Specifically, plaintiffs alleged that CSFB misstated the risk that a weakening advertising market posed to AOL's financial status. *See id.* at 40. The plaintiffs argued that the misleading analyst reports inflated AOL's stock price, which then proceeded to lose value as news of AOL's negative financial condition reached the market and undermined CSFB's projections. *Id.* at 37.

Defendants argued that the court should apply the pleading standards set forth in *Lentell v. Merrill Lynch Co.,* 396 F.3d 161 (2d Cir. 2005), a Second Circuit case decided a few months prior to *Dura*, as *Dura* was too vague to give adequate guidance on the issue of loss causation in cases dealing with third-party analysts. *See In re Credit Suisse,* 465 F. Supp. at 45. *Lentell* requires that a plaintiff "allege that it was the subject of the omission or fraudulent statement that caused the actual loss." *Id.* at 46. Defendants argued that the *Lentell* court had required that, where specific indicia of risk are unambiguously apparent on the face of a defendant's disclosures, plaintiffs must bear the burden of alleging facts sufficient to support an inference that defendant's fraud, rather than other factors, proximately caused the plaintiff's loss, and that the actual subject matter of the fraudulent statement or omission was the cause of actual loss. *Id.* at 48. [190] The *Credit Suisse-AOL* court distinguished and refused to apply the standard in *Lentell* since the defendants' disclosures in the *Credit Suisse-AOL* case were nearly completely optimistic, and the disclosures as to risk were neither specific or ambiguous, with only occasional and generic risk disclosures included in the analyst assessments. *See id.* at 49.

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[190] The *Lentell* court applied a tort analogy and found that this connection established foreseeability of actual loss; foreseeability of proximate causation was sufficient to satisfy loss causation requirements. *Lentell,* 396 F.3d at 172-73.

The defendants also argued that the corrective information about the weakening advertising market was revealed by a decreasing trend in the advertising market, of which the public was already aware. *See id.* at 50. The court found that this argument was irrelevant. The real issue was whether the market was aware of the risk that the advertising market trend posed to AOL's earnings. The court stated that the defendants had not suggested that the public was aware of this risk. *Id.* In fact, the court found that this actually supported plaintiffs' position; namely, that defendants continued to make optimistic reports about AOL despite market trend evidence to the contrary, suggesting that an even stronger vote of confidence was being made by defendants in support of AOL than was typical under normal market circumstances. *See id.* The court concluded that the plaintiffs had adequately pled loss causation, because the defendants had failed to disclose the risks of AOL's financial status and the market was not aware of this risk. *Id*. at 50.

2. Second Circuit

In *Joffee v. Lehman Bros, Inc.*, 2006 U.S. App. LEXIS 31487 (2d Cir. Dec. 19, 2006), the Second Circuit affirmed dismissal of a PSLRA case on loss causation grounds in an unpublished opinion. The case involved an allegation that conflicts of interest led defendants to issue more positive research reports or ratings concerning a covered company than warranted by the financial data. The court found that while there were allegations of price inflation caused by the misrepresentations, the lack of an alleged corrective disclosure and attendant price decline defeated any claim of loss causation. The allegation that the defendants misreported and concealed risks of the covered company that later caused losses was found insufficient because the risks were disclosed in the company's public filings.

In contrast to the decision in *Joffee,* the District Court for the Southern District of New York reached a different view on loss causation in *Lapin v. Goldman Sachs Group.* 2006 U.S. Dist LEXIS 71417 (S.D.N.Y. 2006). In *Lapin,* a case involving charges of tainted analyst research reports issued by Goldman Sachs, the District Court was asked to decide which of two events were the "triggers" of loss causation: 1) the initial public disclosure in April 2002 that the New York Attorney General was investigating conflicts of interest by Wall Street firms, including Goldman Sachs; or 2) the disclosure by regulators in April 2003 of specific Goldman Sachs communications suggesting that Goldman Sachs research reports on specific companies may have been false. The former disclosures caused Goldman Sachs' stock price to decline from $86 a share to $77 a share. In an effort to eliminate the initial stock price drop as a basis for damages, Goldman Sachs contended that the April 2002 disclosures were too generalized to constitute "loss causation" under the PSLRA. The District Court concluded that the April 2002 announcement—clearly more generalized than the disclosures one year later—"could establish that, even without the underlying communications, it was finally revealed to the market that Goldman's research reports were not objective and independent as touted and that they were heavily manipulated by investment banking pressures." *Id.* at *49.

In *Leykin v. AT&T Corp.,* 2007 U.S. App. LEXIS 2378 (2d Cir. Jan. 30, 2007), the district court below had found that investor plaintiffs failed to allege loss causation in a technology misappropriation scheme allegedly responsible for the decline in a stock's price. *See Leykin v. AT&T Corp.,* 423 F. Supp. 2d 229, 234 (S.D.N.Y. 2006). Plaintiffs had made no showing that the stock price decline resulted from any misleading financial statements or alleged

misconduct rather than a market-wide Internet stock collapse. *See id.* at 246, 48. In another unpublished opinion, the Second Circuit affirmed the district court's ruling that the plaintiffs failed properly to allege that the AT&T defendants' conversion scheme was in connection with the purchase or sale of securities, and that any misrepresentation associated with this scheme was the cause of plaintiffs' loss, where the complaint did not allege facts showing that it was the claimed concealment of the scheme that caused plaintiffs' losses, rather than the market-wide Internet stock collapse. *See Leykin,* LEXIS 2378 at *4; *Leykin,* 423 F. Supp. at 246.

The most recent decision from the Second Circuit is *Lattanzio v. Deloitte & Touche LLP,* 476 F.3d 147 (2d Cir. 2007). In *Lattanzio*, investors sued Deloitte for allegedly misleading statements in financial statements included in the 1999 and 2000 annual reports of Warnaco Group, Inc., ("Warnaco"), including the overstatement of total shareholders equity. Warnaco went bankrupt in June 2001, two months after the company filed its 2000 10-K. The Second Circuit observed that to state a claim in this context, plaintiffs needed to show that Deloitte's alleged misstatements "concealed the risk of Warnaco's bankruptcy." *Id.* at 157. Since Deloitte had issued a "going concern" qualification in its audit report, and warned that Warnaco was not in compliance with a number of debt covenants, the Second Circuit found that there were substantial indicia of the risk that Warnaco might file for bankruptcy. As a result, plaintiffs failed to show that Deloitte's misstatements were the proximate cause of plaintiffs' losses, "nor [had] they alleged facts that would allow a fact-finder to ascribe some rough proportion of the whole loss to Deloitte's misstatements. Accordingly, plaintiffs [had] not alleged loss causation." *Id.* at 158.

In *In re Tower Automotive Securities Litigation,* 2007 U.S. Dist. LEXIS 29491 (S.D.N.Y. Apr. 14, 2007), the plaintiff class, investors who had purchased Tower Automotive ("Tower") stock, claimed that defendants made a series of misstatements and omissions regarding integration of Tower's acquisitions, Tower's factoring programs, accounts payable practices, long-term contracts, and bankruptcy planning. *See id.* at *5. The Southern District of New York found that, in their complaint, plaintiffs identified six distinct corrective disclosures, specified the immediate negative impacts of each such corrective disclosure on Tower's stock price, and tied each such corrective disclosure to one of the plaintiffs' claims. *Id.* at *56. The court found that such a showing "amply satisfied" *Dura's* requirement that defendants be provided with some indication of the loss and the causal connection that the plaintiff had in mind. *Id.* at *56.

In *In re Salomon Smith Barney Mutual Fund Fees Litig.*, 441 F. Supp. 2d 579 (S.D.N.Y. 2006), the Southern District of New York dismissed plaintiffs' securities claims for failure adequately to allege loss causation. In this case, class action plaintiffs included investors who purchased or held funds organized and offered by SSB between March 22, 1999, and March 22, 2004. *Id.* at 583. Plaintiffs alleged that, motivated by undisclosed kickback schemes with participating companies, defendant Salomon Smith Barney ("SSB") steered plaintiffs to invest in the proprietary funds of certain companies using cash and non-cash incentives as well as skewed financial publications and data. Plaintiffs claimed that they were damaged by virtue of the fact that they would not have purchased the funds had they known about the allegedly fraudulent practices and would instead have made other investments with higher rates of return, and that they were forced to pay excessive and improper commissions in connection with the purchase of shares in these improperly sold funds. *See id.* at 589. The court reasoned, as to plaintiffs' first claim, that it was really an issue of transaction causation rather than loss causation. In rejecting

this claim, the court also stated that "a shareholder cannot recover for 'damages' based on hypothetical investments he did not make." *Id.* at 589.[191] As to plaintiffs' other claim, the court stated that the complained of fees cannot be tied to a loss suffered as a result of diminution in stock value. *Id.* None of the defendants' alleged misrepresentations could have affected the amount of fees or commissions that would be paid by plaintiffs for the funds. Additionally, defendants at all times disclosed the fee amounts and totals in fund prospectus publications, thus the fees and commissions should have been fully reflected in the fund values. *Id.* In the end, while plaintiffs pointed to reasons they were fraudulently induced to purchase the stock, they could not allege why they lost money on their purchases, thus failing to adequately plead loss causation.

In re AIG Advisor Group Securities Litigation, 2007 U.S. Dist. LEXIS 30179 (E.D.N.Y. Apr. 25, 2007), involved claims that AIG brokers falsely gave the impression that they were providing objective investment advice while actually engaging in an incentive-driven scheme to push the sale of particular stock. *See id.* at *5-6. As in *In re Salomon Smith Barney*, the plaintiffs had several theories of loss causation, including that defendants misled them into thinking that service fees were being paid for certain services that would benefit the plaintiffs, when in reality the fees were being used to fund AIG's incentive sale structure. *See id.* *37-44. The court found that the plaintiffs' claim that, had the true nature of these fees been disclosed, they never would have agreed to them, and absent these fees, plaintiffs' total amount of fees would have been lower, resulting in a smaller reduction in their investment's asset value, survived the heightened pleading requirements as set forth by *Dura*. *Id.* at *43-44. The court reasoned that, even though an objection to the allocation of fees would not be sufficient to prove loss causation where the total fees were disclosed (since the net asset value is similarly reduced regardless of how the fees are apportioned), in this case, had the plaintiffs known the true character of the fees (*i.e.*, they accrued to the defendants' benefit), they would not have paid the fees at all. *See id.* at *41-44. The court found that a rational jury could conclude that AIG's hidden incentive structure and fees proximately caused economic harm to plaintiffs, and found that dismissal of plaintiffs' complaint for failure to allege loss causation was inappropriate. *Id.* at *45.

In *Harrison v. Rubenstein,* 2007 U.S. Dist. LEXIS 13118 (S.D.N.Y. Feb. 22, 2007), the court, in granting defendants' motion to dismiss, found that while plaintiffs adequately alleged transaction causation proximately caused by defendant's misrepresentations, they failed to plead loss causation adequately. *Id.* at *39-40. Plaintiffs failed to allege that fraudulent misrepresentations made by defendants, once their falsity had been made public, actually caused a decline in the stock price of Cornerstone Internet Solutions Company ("Cornerstone"). Plaintiffs did allege that certain negative consequences for Cornerstone's business were caused by an improper licensing agreement entered into by Cornerstone, the orchestration of a sham private placement of a Cornerstone subsidiary, and the improper dilution of Cornerstone's ownership interest in a subsidiary. *See id.* at *37. The court held that since the disclosures regarding mismanagement were not ones that Cornerstone was legally obliged to make, plaintiffs

[191] Citing *In re Morgan Stanley*, 2006 U.S. Dist. LEXIS 20758, at *39 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975)).

allegations of the underlying instances of mismanagement did not establish loss causation. *See id.* at *43. Furthermore, the steady decline in the price of Cornerstone common stock in the absence of disclosures as to these instances of mismanagement, suggested that Cornerstone's stock declined for other reasons. *Id.* at *43-44. The steady decline in stock prices may therefore have had many causes, but plaintiffs failed to allege that fraud was one of those causes. *Id.* at *44-45. The court also denied plaintiffs' motion to amend the complaint a second time, determining that allowing the plaintiffs yet a "third bite at the apple" would not change the fact that their suit was fundamentally without merit. *Id.* at *63.

3. Fourth Circuit

In *Glaser v. Enzo Biochem*,[192] the court affirmed dismissal in a common law fraud case alleging various misrepresentations in an alleged "pump and dump" scheme. The Fourth Circuit adopted a strict interpretation of *Dura's* requirements, and expressly held that plaintiffs must allege that the stock price fell after the truth was revealed:

> It is only after the fraudulent conduct is disclosed to the investing public, followed by a drop in the value of the stock, that the hypothetical investor has suffered a 'loss' that is actionable after the Supreme Court's decision in Dura. In other words, so long as the fraud is undisclosed, normal fluctuations in price attendant to any market may have a direct effect on the investor's portfolio, but cannot be said to be a "loss" that is actionable under the federal securities laws, or as here, the common law of Virginia.[193]

A critical part of the Fourth Circuit's holding is the requirement that the stock price decline be traced to disclosure of the fraud – and that it is not enough to suggest or allege that the stock price decline was somehow related to the problems that were not disclosed.

A very recent decision from the Fourth Circuit sets an even more aggressive standard for pleading of loss causation than the *Glaser* case. In *Teachers' Retirement System of Louisiana v. Hunter*,[194] a divided panel of the Fourth Circuit affirmed dismissal of a shareholder class action on loss causation grounds. The case involved allegedly misleading statements made by Cree, Inc., about business transactions it had with six different companies over a period of several years. In June 2003, the former CEO of Cree sued the company for violations of federal and state securities laws, triggering a stock price decline from $22 to $18 per share. Shortly thereafter, class actions also were filed. The court concluded that the ultimate stock price decline against which plaintiffs were pegging their losses—the announcement of the former CEO's lawsuit—was not associated with any revelations that the company had made any previous representations that were fraudulent. Rather, the court observed that the stock price decline "more logically occurred because the market feared that a lawsuit launched by a founder and former CEO of the corporation portended a period of instability and discord that could disrupt

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[192] 464 F.3d 474 (4th Cir. 2006).

[193] 464 F.3d at 479.

[194] 477 F.3d 162 (4th Cir. 2007).

the corporations operations."[195] The court concluded that this failed to establish loss causation, noting that with respect to the alleged fraudulent transactions with other companies, the adverse facts already had been previously disclosed in prior public filings, such that "their revelation in [the former CEO's] 2003 complaint could not have caused Cree's stock price to decline."[196]

4. Fifth Circuit

In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.,* 2007 WL 1430225 (5th Cir. May 16, 2007), the Fifth Circuit addressed the standard for establishing loss causation at the class certification stage of litigation. Plaintiffs in this purported class action included investors who purchased stock of Allegiance Telecom ("Allegiance") between April 24, 2001, and February 19, 2002. Beginning in April 2001, Allegiance's first, second, and third quarter reports contained positive growth in revenues and earnings. However, the fourth quarter announcement in February contained corrections of certain items in previous reports. Already on a downward move, Allegiance's stock continued to drop the trading day following the fourth quarter announcement, and the company filed for bankruptcy within 90 days. Plaintiffs sued, alleging that officers made misrepresentations in the first through fourth quarter results, and the district court certified a class. On appeal to the Fifth Circuit, plaintiffs unsuccessfully argued that loss causation should not be considered at the class-certification stage of the lawsuit, but the Fifth Circuit held that certification depended on class-wide reliance on alleged misrepresentations, and this reliance was wedded with the element of loss causation through the efficient market hypothesis.[197] The court held that "loss causation [satisfying the predominance requirement] must be established at the class certification stage by a preponderance of all admissible evidence." *Id.* at *6.

This holding has the significant effect of raising the standard in class certification cases, as plaintiffs in securities fraud lawsuits may now be forced to prove loss causation before receiving class action status. It is insufficient for plaintiffs merely to plead reliance (*i.e.*, transaction causation) – plaintiffs also must provide evidence in connection with class certification that a defendant's material misstatement "moved the market" and resulted in their economic loss.

5. Sixth Circuit

The Sixth Circuit's handling of loss causation cases has been limited recently. In *D.E. & J. Ltd. P'shp v. Conaway*,[198] the court (in an unpublished opinion) affirmed dismissal for failure to plead loss causation. This case involved claims of misrepresentations of accounting fraud, based on, *inter alia*, claims that Kmart improperly used interim financial statements containing rebates it hoped to earn from its vendors, had inadequate internal controls on its inventories, and engaged in aggressive efforts to obtain discounts from vendors that hurt the customers. The

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[195] 477 F.3d at 187-88.

[196] *Id.*

[197] *Id.* at *7.

[198] 133 Fed. Appx. 994 (6th Cir. 2005).

Sixth Circuit, applying Rule 8 standards, affirmed the dismissal with prejudice for failure to plead loss causation. Plaintiff's complaint tracked the *Dura* language of inflation upon purchase, but plaintiff contended there were two major differences: (1) an allegation that Kmart's stock dropped upon disclosure it was declaring bankruptcy, and (2) a stock drop upon disclosure of a restatement.

The Sixth Circuit rejected the first argument on the basis that the "filing of a bankruptcy petition by itself does not a securities fraud allegation make," and the failure of the bankruptcy disclosure to contain the circumstances of the alleged fraud defeated any claim of loss causation. This aligns the Fourth and Sixth Circuits in holding that it is price drops caused by disclosure of fraud, and not the deterioration of the company, that creates loss causation. As to the second argument, the Court simply noted that the plaintiff had never actually alleged the connection between the restatement announcement, the fraud, and the price decline.

6. Seventh Circuit

In *Tricontinental Indus., Ltd. v. PricewaterhouseCoopers*,[199] the Seventh Circuit was confronted with claims against PricewaterhouseCoopers arising out of allegedly false financial statements issued in 1997 by its audit client, Anicom, Inc., upon which plaintiff Tricontinental allegedly relied in acquiring Anicom stock as part of an asset purchase agreement in 1998. In July 2000, Anicom announced that it was investigating possible accounting irregularities that could result in the revision of its financial statements in *1998 through 2000.* Applying *Dura,* the Seventh Circuit analyzed the allegedly "curative" disclosures made in July 2000 and concluded that plaintiff failed to show loss causation because Tricontinental could not point to any statements by Anicom or PwC that disclosed any problems or irregularities in the financial statements for *1997*—a different and earlier time period than that which was the subject of the company's July 2000 "curative" disclosures. As a result the Court affirmed dismissal of Section 10(b) claims based upon alleged misrepresentations in the *1997* audited financial statements.

The Seventh Circuit recently affirmed a summary judgment decision dismissing plaintiffs' claim in *Ray v. Citigroup Global Markets,* 482 F.3d 991 (7th Cir. 2007). In that case, investors alleged that a prominent Citigroup broker fraudulently induced them to purchase shares of SmartServ Online, Inc. ("SSOL"), a wireless data service company, based on misrepresentations that SSOL had acquired contracts with large corporations, such as Microsoft, and was considered by defendants to be a safe and lucrative investment. Plaintiffs claimed that defendants' misrepresentations were the cause of SSOL's decline in share value from $80 per share to $1 per share, because SSOL never had the contracts or revenues that the defendants stated they had.

The Seventh Circuit determined that investors failed to show that there was actual loss causation. Citing *Caremark, Inc. v. Coram Healthcare Corp.,* 113 F.3d 645 (7th Cir. 1997), the court affirmed that "but for" transaction causation on the basis of misrepresentations was insufficient to allege loss causation, and that it was necessary to allege that "but for the

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[199] 475 F.3d 824(7th Cir. 2007).

circumstances that the fraud concealed, the investment…would not have lost its value."[200] *Id.* at 995. Investor plaintiffs were unable to rebut evidence that SSOL's losses resulted from a strong downward market trend between 2000-2002 rather than from the alleged misrepresentations. *See id*. Nor could the plaintiffs show that share prices decreased when the alleged misrepresentations were publicly disclosed. In fact, evidence demonstrated that SSOL share values had plummeted some three months before the relevant disclosures. *See id.*

Moreover, there was no evidence that the defendant broker had fraudulently assured investors that SSOL stock was risk free, which might establish loss causation under dicta from *Bastian v. Petren Resources Corp.,* 892 F.2d 680 (7th Cir. 1990). The court did not address whether the "risk-free" approach in *Bastian* survived *Dura*, but found that defendants had never stated that SSOL stock would survive the collapse that the market was currently experiencing. SSOL had been a "volatile" stock since 1999, and defendant broker's encouragements that investors retain their holdings were made in light of this common knowledge. *Id.* at 996.

In another summary judgment case, *In re Motorola Secs. Litig.,* 2007 U.S. Dist. LEXIS 9530 (N.D. Ill. Feb. 8, 2007), plaintiffs alleged that defendant Motorola, Inc., ("Motorola") misrepresented or failed to disclose material facts regarding a series of transactions with a Turkish cellular service provider, concealing from investors a risky business venture that caused shareholder losses when eventually revealed. *Id.* at *3. Motorola argued that the lead plaintiff could not *prove* loss causation under *Dura*, because the series of announcements that lead plaintiff pointed to as "partial corrective disclosures," while reporting negative news, did not involve the misleading representations relating to the Turkish cellular service provider, and that the lead plaintiff also failed to allege that declines in share prices resulted from alleged fraud rather than from a "tangle of other factors" affecting share price. *Id.* at *96-103 (quoting *Dura,* 544 U.S. at 343). The district court concluded that a plaintiff is not necessarily precluded from establishing loss causation where a corrective disclosure does not, on its face, specifically identify or explicitly correct a previous representation. *Id.* at *127.[201] The district court reasoned that, while the standard should not allow every negative announcement to become a potential "corrective disclosure," if a plaintiff can show that the still-concealed fraud is the catalyst for an earnings warning, then the share price decline that follows might serve as a dissipation of the fraudulent price inflation, and such earnings warnings should qualify as a disclosure in which "the relevant truth begins to leak out." *See id.* at *129.[202]

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[200] Citing *Bastian v. Petren Resources Corp.,* 892 F.2d 680 (7th Cir. 1990).

[201] Conversely, another announcement that warned of an earnings shortfall wholly unrelated to Motorola's transaction with the Turkish company was found by the court to be inadequate to establish loss causation, because the lead plaintiff did not show that the earnings warning was made in anticipation of alleged fraud-related activities. The court required this specificity in each of the announcements plaintiffs identified, and eventually granted and denied in part Motorola's motion for summary judgment on loss causation grounds. *Id.* at 133.

[202] Quoting *Dura Pharms*., 544 U.S. at 342.

7. Ninth Circuit

In *Knollenberg v. Harmonic, Inc.*,[203] the Ninth Circuit affirmed dismissal of Section 10(b) claims by memorandum disposition, finding *inter alia* that plaintiffs failed to allege loss causation. In that case, a class action suit was filed within days of Harmonic's issuance of a press release disclosing that the company's anticipated revenues for the second quarter of 2000 were going to be *half* of what the company previously had projected. The day after this press release, the stock price dropped 47 percent, from over $40 a share to just over $23 per share. Nevertheless, the Ninth Circuit affirmed dismissal, stating that "although they alleged that the named representatives for the putative class purchased stock during the class period and that the stock price then fell, they do not allege that any of these same Plaintiffs sold stock at a loss caused by the Defendants' fraud or misrepresentation." The possible explanation for this holding—which is not otherwise explained—is that the basic theory of fraud advanced by the plaintiffs was that Harmonic had issued misleading statements designed to induce shareholders to approve a May 2000 acquisition by Harmonic of a division of another company called C-Cube. Following plaintiffs' theory, Harmonic arguably would have been acquiring C-Cube's division with inflated shares—a fact that would have *benefited* Harmonic shareholders in connection with the acquisition, not harmed them. Viewed this way, the Court's finding that plaintiffs failed to establish loss causation makes sense.

The *Knollenberg* decision was the second decision from the Ninth Circuit in a period of just seven months to address loss causation. In the first, *In re Daou Systems, Inc. Sec. Litig.*,[204] the Court adopted *Dura's* "notice pleading" principle that plaintiffs need only allege facts showing "some indication" that the company's stock price decline was causally related to the disclosure of an alleged misrepresentation. Helpfully, however, the Ninth Circuit found that stock price declines that preceded the first revelations of adverse facts in August 1998 must be ignored, and that any loss in value of the company's shares prior to that time "cannot be considered causally related to Daou's allegedly fraudulent accounting methods because, before the revelations began in August 1998, the true nature of Daou's financial condition had not yet been disclosed." 411 F.3d at 1027.

Besides the unpublished Ninth Circuit decision in *Knollenberg*, a number of district court decisions within the Ninth Circuit have addressed loss causation issues in the last year. In May 2006 for example, in *In re Gilead Sciences Securities Litigation*, 2006 WL 1320466 (N.D. Cal. May 12, 2006), the Northern District of California granted a defendants' motion to dismiss for failure to meet the requirements of pleading loss causation under *Dura. See id.* at *10. Class action plaintiffs alleged that a series of off-label marketing activities by Gilead Sciences, Inc., ("Gilead") misleadingly promoted the antiretroviral drug Viread. Plaintiff class members were those who purchased Gilead shares between July 14, 2003, and October 28, 2003. Plaintiffs alleged that aggressive off-label promotion (*i.e.*, marketing of the drug inconsistent with the contents of FDA-approved package labels) began in September 2001 and was responsible for

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[203] 2005 U.S. App. LEXIS 24274 (9th Cir. 2005) (reviewing *In re Harmonic, Inc. Secs. Litig.*, 2002 U.S. Dist. LEXIS 26676 (N.D. Cal., Nov. 13, 2002)).

[204] 411 F.3d 1006 (9th Cir. 2005).

over 85% of Viread sales, which grew to 20% of the antiretroviral drug market share. *Id.* at *3. The FDA issued a warning letter in July 2003 indicating that a Gilead representative had made improper promotional statements about Viread. This warning letter was made public on August 7, 2003. *Id.* An October 28, 2003 press release indicated widespread reductions of Viread in wholesale pharmaceutical inventory. Gilead's stock value suffered a significant drop on the following day. *Id.* at *7. Specifically, plaintiffs alleged that Gilead's off-label marketing caused an increase in prescriptions and sales, creating "explosive growth" in demand that was then slowed by the FDA warning letter, which caused a slow down in sales and a stock decline. *Id.* Plaintiffs also alleged that decreases in sales and share values were a foreseeable result of Gilead's marketing techniques. *Id.*

The district court found that plaintiffs failed to allege the requisite causal connection between the off-label marketing and FDA warning letter that followed and the subsequent drop in Gilead's share price. *See id.* at *7. It was too tenuous for plaintiffs to allege that a public revelation of the FDA warning letter in early August caused the stock price drop three months later in October. *Id.* Plaintiffs' attempt to connect the FDA warning letter with a lower demand for Viread (and thus presumably the announcement of disappointing sales the day prior to the stock price drop) was unsuccessful. *See id.* at 7. The court found that plaintiffs' assertions that the FDA warning letter was the cause of the lower demand did not establish the causal connection. *Id.* In fact, market analyst reports continued to predict growing demand for Viread, undermining plaintiffs' theory that the disclosure led to a decrease in demand. *Id*. Because no causal connection could be established between public disclosure of the FDA warning letter and subsequent lower demand for Viread, the court held that plaintiffs failed to meet heightened pleading standards of the PSLRA, and granted Gilead's 12(b)(6) motion to dismiss. *Id.* at *1.

Another recent Northern District of California case also sends encouraging signals as to how some district court judges are embracing *Dura* and dismissing cases on loss causation grounds. In *In re Impax Laboratories, Inc. Sec. Litig.,* [205] the court threw out a class action case on loss causation grounds based upon a very technical comparison of stock price movements in relation to specific disclosures of adverse information. Specifically, the court found in several instances that the company's stock price actually *increased* following the disclosure of adverse information, thus defeating loss causation—even when the announcement in question also was accompanied by arguably offsetting *positive* announcements. Similarly, the court strictly construed *Dura* to require that, to the extent plaintiffs were alleging fraud in relation to the company's first and second quarter 2004 results, any alleged "curative" disclosure must directly reveal something "curative" about those two quarters—not some other quarter. Thus, the court found that the company's November 2004 press release failed to support plaintiffs' loss causation contentions, since that press release only addressed results for the *third* quarter.

With similar logic, the Northern District of California dismissed a complaint for inadequate loss causation pleading when stock prices had already dropped significantly prior to a corrective disclosure. *In re Redback Networks, Inc. Sec. Litig.,* 2007 U.S. Dist. LEXIS 27389 (N.D. Cal. Mar. 30, 2007). In *Redback*, plaintiff investors alleged that defendant officers and

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[205] 2007 U.S. Dist. LEXIS 723 (N.D. Cal. Jan. 3, 2007).

directors of Redback Networks, Inc. ("Redback") engaged in a scheme to defraud the market. The plaintiff class was comprised of investors who purchased Redback stock between November 27, 1999, and October 10, 2003. *Id.* at *4. Specifically, plaintiffs alleged that Redback essentially "bought" revenues through bribery and *quid pro quo* arrangements, and that these additional revenues gave the public a more positive impression of Redback which inflated its stock price. *Id.* at *5. The court found, however, that the resulting revenue was real and was earned by Redback in return for the sale of its products. *Id* at *15-16. Plaintiffs alleged that, in June 2001, the improper revenue began to dry up, while the truth about Redback's alleged fraudulent practices came to light in October 2003. *Id.* at *5-6. The court concluded that only a negligible portion of the drop in stock price during the class period was caused by Redback's alleged fraud, because share prices had already dropped significantly from $150 to less than $12 per share prior to June 2001. *See id.* at *18-19. By the time the actual concealed facts about the fraudulent practices relating to sales became public, the share price had already dropped to below $1 per share. *Id.* Thus, the court concluded, only a negligible portion of the stock price drop was caused by the alleged fraudulent practices relating to sales. *Id.* at 19. In granting leave to amend, the court stated that it would be helpful to the court's understanding if plaintiffs clearly alleged what portion of the drop was caused by the alleged fraud. *Id.* at 20.

Finally, in *In re Cornerstone Propane Partners, L.P. Securities Litigation*, 2006 U.S. Dist. LEXIS 25819 (N.D. Cal. May 3, 2006), a California district court ruled on a motion to certify a class pursuant to Rule 23. *See id.* at *9, *31. Plaintiffs defined their class to include all persons and entities who acquired defendant CornerStone Propane Partners L.P. ("Cornerstone") stock between July 29, 1998, and February 11, 2003. *Id.* at *7. CornerStone's stock decline began following a press release on July 27, 2001. *Id.* at *6. CornerStone argued that certain plaintiffs in the purported class bought and sold shares prior to the first corrective disclosure could not adequately plead loss causation. *See id.* at *25, *31. The court held that, pursuant to *Dura*, the plaintiff class was foreclosed from including any individuals who had purchased or sold Cornerstone stock prior to the first corrective disclosure on July 27, 2001. *Id.* at *31.

D. Key Issues Being Litigated after *Dura*

1. Split Among the Courts as to Application of Rule 8(a) or Rule 9(b)

The majority of courts apply Rule 8(a) of the Federal Rules of Civil Procedure in evaluating the sufficiency of loss causation allegations under *Dura*.[206] The issue is whether loss causation is one of the "circumstances constituting fraud." The logical view is "yes," that without causation of loss, there is no fraud, and the causation of harm is one of the key elements of reputational harm underlying Rule 9.

[206] *See In re Tower Automotive Securities Litigation,* 2007 LEXIS 29491, at *56 (S.D.N.Y. Apr. 14, 2007) (noting that "nearly all courts addressing the issue [since *Dura*] have also applied Rule 8, rather than the heightened pleading standard of Rule 9").

Examples of cases in which the district court applied Rule 8(a) include *Ong v. Sears Roebuck & Co.*,[207] In *Ong,* the court denied the defendants' motion to dismiss, finding that Rule 8(a) applied, and that *Dura* only required pleading of "some indication" of loss. The court therefore found *Dura* satisfied, although the complaint failed to allege any specific price decline following the two specific offerings upon which underwriters were sued. The district court held that "nothing in Dura alters the Seventh Circuit's approach."[208]

2. Temporal Relationship of the Price Decline and the "Curative" Disclosure

Similar to the decision in *Dura II,* district courts have struggled with the issue of whether all the "curative" facts must be disclosed at the time of a stock price decline, or whether the "truth" can be disclosed later.

Several courts have *not* required disclosure of "fraud" per se, but only facts sufficient to reveal the general adverse conditions or circumstances.[209] With accounting fraud claims, some courts have concluded that *Dura* does not require disclosure that the "books were cooked," but rather simply the disclosure of facts establishing the true financial picture of the company. In *Daou* it was that the company's disclosure of increased unbilled receivables that tied directly to plaintiffs' allegations of financial fraud in the form of premature recognition of revenue. Nor is it necessarily essential that the fraud be the only, or even primary reason for the price decline, according to some court decisions, so long as it is a substantial causative factor, and therefore consistent with basic principles of proximate cause. For non-accounting fraud, the tie between the disclosure and the underlying fraud arguably must be tighter, as the mere revelation of financial difficulties doesn't disclose "non-financial" fraud. So, it is easier for a plaintiff to plead loss causation, and a viable "leakage" claim, with accounting fraud, as opposed to other types of fraud.

3. Claims Against "Secondary Actors"

Various decisions in 2006-07 addressed how the plaintiffs' bar has attempted to plead loss causation against secondary actors accused of participating in a "scheme to defraud."

The *Enron* Cases. In the consolidated cases known as the *In re Enron Securities, Deriv. & ERISA Litigation*, the district court's decisions highlight the issue post-*Dura* on how loss causation principles may or may not apply to claims against secondary actors in connection with "scheme" liability. In 2006, the district court granted class certification in the case, rejecting arguments of various defendants that due to the very different and limited roles they played in

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[207] 459 F. Supp. 2d 729 (N.D. Ill. 2006).

[208] *See also The First Union Corp Sec Litig*., 2006 U.S. Dist. LEXIS 5083 (N.D.N.C. Jan. 20, 2006) (compiling cases on 8(a) versus 9(b)); *In re Espeed Sec. Litig*., 457 F. Supp. 2d 266 (S.D.N.Y. 2006) (applying 8(a)); *Asher v. Baxter Int'l*, 2006 U.S. Dist. LEXIS 4821 (N.D. Ill. Feb. 7, 2006) (same).

[209] *See, e.g., In re Daou Sys*., 411 F.3d 1006 (9th Cir. 2005); *Lapin v. Goldman Sachs Group,* 2006 U.S. Dist. LEXIS 71417 (2d Cir. 2006).

connection with discrete transactions alleged to be part of a continuing fraud, Rule 23 prevented certification of a broad class involving multiple secondary actors with no specific allegations—much less proof—that their involvement in those discrete transactions caused any loss to class members. Defendant Merrill Lynch, in particular, contended that its limited role in one or two transactions could not have caused loss to class members. Judge Harmon turned back those arguments, despite the fact that the Enron experts appear to have acknowledged that if the alleged fraudulent acts of Merrill Lynch had not taken place, Enron's stock price *still* would have collapsed—the antithesis of loss causation, one might argue.[210]

On appeal, the Fifth Circuit reversed Judge Harmon's class certification decision, holding that Merrill Lynch's alleged conduct could not be found to constitute "primary liability" under Section 10(b) as against the entire class of purchasers of Enron securities over a multi-year time period. Therefore, the district court erred in granting class certification.[211] In his concurring opinion, Judge Dennis addressed the loss causation issue involved when multiple actors are alleged to have engaged in a multi-year "scheme," while no single actor may have been a participant in all the events and circumstances underlying the alleged "scheme." In at least one helpful comment, Judge Dennis stated that "not every plaintiff will be harmed by every defendant," and that a defendant who came along late in the alleged "scheme" would not be liable to investors who purchased before the transaction in which that defendant was involved. "Since those investors purchased their stock before the defendant engaged in any fraudulent conduct, they could not state a Section 10(b) claim against it, because they would be unable to show either that the defendant's conduct caused them to purchase Enron stock at an inflated price… or that it caused them any harm (the element of loss causation)."[212] Although Judge Dennis did not cite to *Dura* in his analysis, he effectively interpreted *Dura* to bar damages if, as in Enron, a defendant's conduct was not coincident with both an inflationary event (in that case, specific transactions that caused Enron's financial results to be overstated), and loss directly linked to that inflationary event.

In another decision in the *Enron* litigation involving a different bank defendant (prior the Fifth Circuit's reversal of her class certification ruling), Judge Harmon offered guidance on loss causation in connection with a motion for judgment on the pleadings by defendant Barclays PLC. In the motion brought by Barclays, the *Enron* court considered the question whether Barclays, as a secondary actor, could be held in the case based upon Plaintiffs' overall "scheme" allegations, and if so, how the "scheme" liability might be linked to evidence of loss causation. In *In re Enron Corp. Securities, Deriv. & ERISA Litig.*,[213] Judge Harmon noted that the complaint did not literally allege that plaintiffs' losses were caused by Barclays' purported misconduct. Judge Harmon also found that plaintiffs alleged that it was Enron and its accountants, officers, etc., *not* Barclays, that purportedly used or employed artifices to deceive,

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[210] *See, e.g., Regents of the University of California v. Credit Suisse First Boston (USA) Inc.,* 2006 U.S. Dist. LEXIS 43146 (S.D. Tex. 2006).

[211] 482 F.3d 372 (5th Cir. 2007).

[212] *Id.* at 407.

[213] 439 F. Supp. 2d 692 (S.D. Tex. 2006).

and created a false impression of a financially strong Enron. Thus, she said, "the allegations at most portray Barclays as a culpable aider and abettor." She therefore ruled in favor of Barclays, finding that plaintiffs had failed to plead a claim for primary liability against Barclays. *However,* she went on to make several observations in dicta about loss causation, ostensibly to "guide other Defendants whose alleged acts might constitute primary violations of Section 10(b)," that are troubling. *First,* she ruled that the identity of a particular primary wrongdoer need not be disclosed, or otherwise known to injured investors, to establish loss causation as a result of that wrongdoer's alleged conduct. *Second,* she said that if the primary violations of *other* wrongdoers "with the same purpose" is "leaked or disclosed to the market and causes a steep decline in the price of [the] stock," then the undisclosed wrongdoer may be held liable for those losses. That is, "disclosure of the roles of *some* primary violators"—not necessarily the violator who is moving to dismiss—"should be viewed as sufficient to show loss causation for later-disclosed actions... of other defendants substantially contributing to the fabrication of [] assets and the hiding of debt in the same scheme."

The *Global Crossing* Cases. In *In re Global Crossing Sec. Litig*.,[214] the court held that investors could amend their complaint to add new claims against two secondary actors, Microsoft and Softbank, as counterparties to various sales and exchanges of bandwidth with Global Crossing. In deciding whether to grant leave to amend, the district court necessarily addressed whether the proposed amended complaint satisfied the requirements for pleading loss causation. The court held that it had, "if just barely." The complaint alleged, for example, that Microsoft could be linked to loss caution by virtue of its alleged public assurances of its intent to purchase $100 million in capacity from Global Crossing over the following three years, when in fact it failed to honor those commitments—allegedly contributing to subsequent stock price declines, and ultimately to Global Crossing's bankruptcy. Setting the bar extremely low, the Court held that this allegation was sufficient, although "dubious." Indeed, one could argue that the court's ruling amounted to turning garden variety contract partners into primary participants in the alleged fraud—stretching the borders of both primary liability and loss causation principles.

The *AOL* Cases. In *In re Credit Suisse-AOL Sec. Litig*.,[215] the court denied Credit Suisse's motion to dismiss, finding that the complaint adequately alleged loss causation as to Credit Suisse for failing to disclose the impact that the advertising market had on AOL's financial status. In particular, the court found that Credit Suisse *research reports* had an impact on AOL's stock price, and that loss causation is made out when the "inaccuracy of the earlier recommendations is revealed and the stock price falls." Although the Credit Suisse research reports had discussed certain risks posed to AOL due to the uncertainty in the advertising market, the district court concluded that these disclosures were not "specific" or "unambiguous" (distinguishing the Second Circuit decision in *Lentelll v. Merrill Lynch,* 396 F.3d 161 (2d Cir. 2005). The court also rejected the argument that investors already were aware of the known risks to AOL.

[214] 2006 U.S. Dist. LEXIS 39030 (S.D.N.Y. June 13, 2006).

[215] 2006 U.S. Dist. LEXIS 86363 (D. Mass. Nov. 30, 2006).

4. The Role of Economic Modeling

Despite many decisions around the country applying *Daubert* principles to exclude damages opinions in securities cases based on "junk science," at least two recent decisions appear to give plaintiffs' counsel broad leeway to use "junk science" and debatable statistical data in order to plead loss causation and survive a motion to dismiss.

In *The Takara Trust v. Molex Corporation*,[216] the Northern District of Illinois denied the defendants' motion to dismiss on the grounds, *inter alia,* that the complaint had attached and relied upon a lawyer-created "composite index" of allegedly comparable company stocks, and that the index demonstrated a plausible basis for concluding that defendant Molex's stock had traded four percent lower that the index following curative disclosures issued in late 2004. The district court said that "no appellate court has affirmatively determined that a four percent drop in stock prices due to misleading or false information is immaterial as a matter of law, and this Court will not make such determination at this point." The court elsewhere quoted from the complaint that a four percent stock drop "is very statistically significant and evidences that the downturn in Molex' stock price is attributed to the dissipating inflation caused by defendants' earlier false statements, rather than some market or industry trend."

The *Takara Trust* decision is dangerous on several levels, but chief among its errors is that a company's disclosure of firm-specific news—including "new news"—may often cause firm-specific stock price movements that are not in sync with "market or industry trends." The mere fact that a disclosure causes a company's stock price to deviate from an industry "composite index" is *not* proof of loss causation—it is merely proof that the stock may have reacted to a public disclosure, for any number of reasons that are not necessarily attributable to "fraud." The opportunity for plaintiffs' lawyers to "cherry pick" a "composite index" that can be used to presume loss causation at the pleading stage is a cause for concern.

In *City of Sterling Heights Police & Fire Retirement System v. Abbey Nat'l, Inc.*,[217] the Southern District of New York held that allegations that the company had failed to disclose its massive investment risk due to investments in WorldCom sufficiently alleged loss causation. The court relied, *inter alia,* on evidence that when Abbey National disclosed its aggregate holdings in Worldcom in June 2002, the stock price declined 4.3%. The court observed that, while defendants might ultimately show that some intervening event caused the loss, "such is a matter of proof at trial."

5. Claims of In-and-Out Traders

Does *Dura* eliminate the claims of "in and out" traders? The consensus is "probably," at least prior to any "leakage" of the fraud to the marketplace, but the issue is typically not resolved at the class certification stage. For example, in *In re Bearingpoint, Inc. Sec. Litig.*, [218] the court

[216] 429 F. Supp. 2d 960 (N.D. Ill. 2006).

[217] 423 F. Supp. 2d 348 (S.D.N.Y. March 31, 2006).

[218] 386 F. Supp. 2d 913 (E.D. Va. 2006).

held that in-and-out traders may be able to prove loss causation, and certifying class including such class members.[219]

6. "Holder" Claims

Does *Dura* allow claims to be brought by "holders"? District courts have considered whether plaintiffs must have sold their securities following a curative disclosure in order to have standing to sue. In *Ong v. Sears Roebuck,*[220] for example, the district court held that there is no so-called "sell to sue" requirement under *Dura*—plaintiffs may sue for economic loss regardless of whether they subsequently sell the securities, or sell at a price that may not be affected by the curative disclosure. In *Dura II,* the district court rejected the contention that permitting a claim based upon post-class period disclosures amounted to creation of a "holder" class, since class members at least purchased securities when the price allegedly was affected by material misrepresentations.[221]

VII. RECENT DEVELOPMENTS UNDER SLUSA

A. The *Kircher* Cases

Only three months after the United States Supreme Court's decision in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 574 U.S. 71 (2006), the Court once again issued a SLUSA interpretation in *Kircher v. Putnam Funds Trust*, 126 S. Ct. 2145 (2006). In *Kircher*, the Court held that defendants are prevented from appealing even clearly erroneous district court denials of removal. Despite the fact that the *Kircher* claimants alleged substantially identical claims to those alleged in *Dabit*,[222] and despite the fact the Seventh Circuit had determined removal was appropriate, the Supreme Court reversed pursuant to a general bar against appealing denials of removal codified in 28 U.S.C. § 1447(d).

The *Kircher* line of cases begins with *Kircher I*[223], where the Seventh Circuit held that SLUSA remands were reviewable notwithstanding the general bar on appeals, which provides an "order remanding a case to the State court from which it was removed is not reviewable on appeal or otherwise . . . ."[224] Recognizing that its decision conflicted with that of two other circuits, the Seventh Circuit nonetheless held that the district court determination that plaintiffs' claims were not preempted by SLUSA was substantive rather than jurisdictional and therefore

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[219] *Compare In re Cornerstone Propane Partners, LP,* 2006 U.S. Dist. LEXIS 25819 (N.D. Cal. 2006) (in-and-out traders excluded from class certified); *Glaser v. Enzo Biochem, supra* (court notes that plaintiffs had sold their shares prior to the curative disclosure, and therefore could not establish loss causation under *Dura*).

[220] *Supra* at *Ong v. Sears Roebuck & Co.,* No. 03 C 4142, 2006 U.S. Dist. LEXIS 80294 (Oct. 18, 2006).

[221] *Compare Royal Dutch Shell*, 404 F. Supp. 2d 605 (D.N.J. 2005) and *Knollenberg, supra*.

[222] In *Dabit,* the Court ruled that SLUSA had a broad preemptive reach and that holder claims – where plaintiffs allege that they would have sold securities absent material misrepresentations or omissions – are precluded by the statute.

[223] *Kircher v. Putnam Funds Trust*, 373 F.3d 847, 848 (7th Cir. 2004) (*Kircher I*).

[224] 28 U.S.C. § 1447(d).

Section 1447(d) was not applicable.[225] The court explained that "[a]ppellate review of [such] decisions . . . will promote accurate and consistent implementation of [SLUSA], at little cost in delay beyond what the authorized removal itself creates. Yet if the remand is deemed non-appealable, then a major substantive issue in the case will escape review."[226]

Litigation then proceeded in the Seventh Circuit on the substantive preemption claim, where the court held that plaintiffs' holder claims were precluded by SLUSA.[227] This decision became part of the circuit split that led the Supreme Court to grant certiorari in *Dabit*, where the Court explicitly approved of the Seventh Circuit's reasoning stating that "[t]he background, the text, and the purpose of SLUSA's pre-emption provision all support the broader interpretation adopted by the Seventh Circuit."[228]

While these proceedings continued in the Seventh Circuit, the Supreme Court granted certiorari on the predicate procedural question of appealability resolved in *Kircher I*.[229] Notwithstanding the Supreme Court's approval in *Dabit* of the Seventh Circuit's reasoning on the merits in *Kircher II*, the Court determined that the Seventh Circuit's review of the substantive questions was improper.[230] The Court held that the Seventh Circuit erred in characterizing the district court's remand as substantive rather than jurisdictional, and held that SLUSA "does not exempt remand orders from 28 U.S.C. § 1447(d) and its general rule of nonappealability."[231] The Court emphasized that federal courts are not the only forums that can decide these issues, noting that state courts are "equally competent" bodies, and that a state court on remand is "perfectly free to reject the remanding court's reasoning" on the issue of preclusion.[232]

In the wake of *Kircher*, there can be no federal court review of a remand to state court, "whether or not that order might be deemed erroneous."[233] Challenges to SLUSA removal and preclusion, therefore, will only be heard on appeal by *plaintiffs* from district court decisions granting preclusion. Although this asymmetrical right of appeal seems to be in significant tension with Congress' desire to create a uniform set of standards and law relating to securities class actions, absent a statutory amendment, defendants will be forced to argue the merits of preclusion pursuant to remand orders in state courts.

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[225] *Kircher I*, 373 F.3d at 850.

[226] *Id.*

[227] *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005) (*Kircher II*).

[228] *Dabit*, 126 S. Ct. at 1507.

[229] *See Kircher v. Putnam Funds Trust*, 126 S. Ct. 2145 (2006) (*Kircher III*).

[230] *Id.*

[231] *Id.* at 2157.

[232] *id.* at 2156 - 57.

[233] *Id.* at 2153.

B. Other Recent Decisions and Unresolved Issues Under SLUSA

1. Covered Class Actions

In *W.R. Huff Asset Mgmt. Co. v. Kohlberg, Kravis, Roberts, KKR Assocs. LP*, 209 Fed. Appx. 931 (11th Cir. 2006), the Eleventh Circuit held that a district court abused its discretion by rejecting plaintiffs' amended complaint, which removed enough plaintiffs in order to fit under the statutory threshold of fifty or more plaintiffs.[234] In *W.R. Huff*, after filing its third amended complaint, the plaintiff filed a motion for leave to amend again requesting to narrow the number of plaintiffs to forty-six in order to stay outside of SLUSA's reach.[235] The district court denied leave to amend. In reversing the Eleventh Circuit held that the denial was an abuse of discretion in part because no court had yet reviewed the substance of the claims and there was "no undue burden on [defendant] when the litigation – though long-lived – had not yet progressed beyond the pleading stage."[236]

In *Peregrine Litigation Trust v. John J. Moores et al.*, No. gic-788659 (San Diego Sup. Ct. Cal. May 2, 2007), the addressed the question of what types of trusts deserve entity status when counting the number of plaintiffs.[237] The *Peregrine* suit was brought pursuant to a trust set up by a bankruptcy judge in order to seek recovery of losses against former directors and executives in the wake of high-profile shareholder losses. Because this trust was created with the purpose of filing suit on behalf of more than 50 shareholders, the court found the action precluded under SLUSA and dismissed the trust's claims. The court held that the Chapter 11 Trustee was "one person" because she was created for "all purposes" and "not just for the purpose of pursuing causes of action."[238]

2. Claims Based Upon Misrepresentations or Material Omissions

In order to plead around SLUSA in the wake of *Dabit*, plaintiffs have been stripping their claims of all allegations of misrepresentation, and arguing that their claims are not within the ambit of the Securities Act. These cases rely on *Santa Fe Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), where the Court held that allegations of corporate mismanagement alone, without any attendant misrepresentation or deception, do not give rise to liability under the Securities Act § 10(b) or Rule 10(b)-5.

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[234] Some courts have held that procedural maneuvers aimed at evading SLUSA preemption are barred. *See In re Worldcom Securities Litigation*, 2004 U.S. Dist. LEXIS 5410, at *20-21 (S.D.N.Y. Apr. 2, 2004) (refusing to allow plaintiffs to intentionally avoid SLUSA through voluntary dismissal of class members).

[235] *Id.* at 933.

[236] *Id.* at 935.

[237] Under SLUSA, trusts and corporations can be given entity status and treated as one individual, but "only if the entity is not established for the purpose of participating in the action." 15 U.S.C. § 78bb(f)(5)(D).

[238] *Id.* at 1008; *see also Lee v. Marsh & McLennan Cos.*, 2007 U.S. Dist. LEXIS 16489, at *16-18 (S.D.N.Y. Mar. 7, 2007) (holding that trustee deserved entity status because the trust was for the purpose of managing property and the new trustee was appointed only to avoid a conflict of interest rather than for the purpose of pursuing litigation).

Most courts to have addressed the issue have determined that claims omitting allegations of misrepresentation or material omission are not removable and preempted by SLUSA. *See Drulias v. ADE Corp.*, 2006 U.S. Dist. LEXIS 43285, at *6 (D. Mass. June 26, 2006) (holding that breach of fiduciary duty claims based upon conflict of interest rather than material misrepresentation are not preempted by SLUSA); *Paru v. Mut. of Am. Life Ins. Co.*, 2006 U.S. Dist. LEXIS 28125 (S.D.N.Y. May 11, 2006) (holding that breach of fiduciary duty claim alleging harm from market timing practices was not preempted because it did not allege misrepresentations or omissions); *Gurfein v. Ameritrade, Inc.*, 2006 U.S. Dist. LEXIS 75374 (S.D.N.Y. Oct. 16, 2006) (holding that repleading misrepresentation claim into breach of contract claim avoided SLUSA preemption, but finding that the complaint failed to make out a contract violation).

Other courts, however, have found that when securities plaintiffs remove allegations of misrepresentation and fraud, and re-plead actions as corporate mismanagement claims, the actions become derivative in nature and cannot thereby be pursued in a class action form. *See Potter v. Janus Capital Management LLC*, 2007 U.S. Dist. LEXIS 25804, at *28 (S.D. Ill. Feb. 1, 2007); *see also Kircher II*, 403 F.3d at 483 ("A claim based on mismanagement likely would need to be cast as a derivative action, which none of these suits purports to be.")

3. "In Connection With"

In *Gavin v. AT&T Corp.*, 464 F.3d 634 (7th Cir. 2006), the Seventh Circuit held that alleged fraud is not "in connection with" the sale of a covered security when the allegedly fraudulent actions related not to the actual transaction, but to subsequent procedures for claiming the results of a transaction. In *Gavin*, certain shareholders of Media One, which merged with AT&T in 2000, brought suit in state court regarding a letter that informed shareholders they could claim their stock in AT&T with a transaction charge of $7 per share. The letter was allegedly fraudulent because it failed to inform the shareholders of an alternate procedure for claiming the shares without incurring any additional costs.[239] Upon defendants' removal, the district court accepted jurisdiction and held the suit preempted under SLUSA. The Seventh Circuit reversed, however, holding that the letter was not in connection with the sale of a security. The court noted that "[t]he merger was the sale," and behavior that occurs after a transaction is complete "is a separate wrong . . . unless the wrong is a breach of warranty."[240]

4. "Delaware Carve-Out"

No Court of Appeal decisions in the last year have interpreted SLUSA's so-called "Delaware carve-out," but there have been a few district court cases interpreting this provision.

In *Lewis v. Termeer*, 445 F. Supp. 2d 366 (S.D.N.Y. 2006), the court determined that sales of stock by individual investors in the open market could fall within the Delaware carve-out when connected with statements of an issuer surrounding an exchange of stock related to a

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[239] *Id.* at 638.
[240] *Id.* at 639.

merger. When a corporation announced that it would exchange all outstanding stock, some members of the Plaintiff class executed the exchange while others opted out by selling in the open market.[241] The Delaware carve-out of SLUSA only exempts actions that involve the "purchase or sale of securities by the issuer . . . exclusively from or to holders of equity securities of the issuer." 15 U.S.C. § 78bb(f)(3)(A)(ii)(I). The court refused to dismiss the action and held that even those plaintiffs who opted out of the exchange "may be able to show that their state law claims stem from the existence and purpose of the Exchange or the defendants' communications, 'duties and performance' in connection with the Exchange, and are thus preserved."[242]

In *Proctor v. Vishay Intertechnology, Inc.*, 2007 U.S. Dist. LEXIS 14547 (N.D. Cal. Feb. 13, 2007), the plaintiffs alleged several claims, including a state law derivative action, relating to misrepresentations and false reports that occurred over an extended period of time before a tender offer. The court first held that the exemption for derivative actions did not apply because plaintiffs did not "exclusively" pursue such a claim.[243] The plaintiffs also argued, however, that their claims were excluded from SLUSA's reach by the Delaware carve-out provision. Defendants argued that the claims could not fit within the carve-out because the alleged misstatements did not "concern shareholders' actual exercise of voting rights," but were instead "a long series of actions that may have had a delayed impact on the exercise of such rights."[244] The court agreed with the defendants and determined that plaintiffs' conception of the carve-out would be "far too broad."[245] The court therefore held that the "Delaware carve-out relates only to communications that are directly related to the exercise of shareholders' voting rights."[246]

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[241] *Id.* at 372.

[242] *Id.* at 373; *see also In re Metlife Demutualization Litigation*, 2006 WL 2524196, at *6 (E.D.N.Y. Aug. 28, 2006) (holding that the term "involve" indicates that "a number of securities may be purchased or sold").

[243] *Id.* at *18.

[244] *Id.* at *20.

[245] *Id.* at *21.

[246] *Id.*