Practising Law Institute
Securities Litigation and Enforcement Institute 2007

October 15, 2007
San Francisco, CA

Current Trends in Federal Securities Litigation

Jonathan C. Dickey
Gibson, Dunn & Crutcher LLP
Palo Alto, California

 The author gratefully acknowledges the assistance of the following lawyers of Gibson, Dunn & Crutcher in the preparation of this paper: Daniel Floyd (partner), Sally Berens, Jeffrey Minnery, Jonathan Rosenblatt, Virginia Boster, and Nathan Chase (associates). The following 2007 Gibson, Dunn & Crutcher summer associates also contributed to the preparation of this paper: Jameson Jones; Jonathan Krop; Elvin Lee; Nicole Raspa; and Joyce Wang.

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

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 more rigorous pleading standard under the Private Securities Litigation Reform Act than the standard adopted by the Supreme Court in that case—an indication, perhaps, that the position of the SEC on such issues cannot be easily predicted.

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 can credibly say 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

---

[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.

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.

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

---

[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).

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

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

---

[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.

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]

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

---

[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.

[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).

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]

---

[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

[Footnote continued on next page]

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

> 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

---

[Footnote continued from previous page]
Reporting Institute Conference, Sec. Reg. & L. Rep. (BNA) (June 19, 2006).

[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).

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 mind has not been

---

[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*.

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

---

[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.*

"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 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

---

[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).

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

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:

---

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

- 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."

- 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."

---

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

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.

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

---

[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).

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.

---

[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.

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.

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

---

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

step forward. The Commission's Working Paper was largely based upon an independent study by London Economics.[36]

In sum, the idea of some form of liability "caps" or other reforms relating to litigation against auditors is gaining traction both in the United States and Europe. By the end of 2007, we should expect to see greater clarity on whether meaningful reforms will be enacted.

III. RECENT CASE LAW ON PLEADING STANDARDS

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, culminating in the Supreme Court's recent decision in the *Tellabs* case (discussed below). 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). Congress did not, however, specifically define what was required to plead a "strong inference." 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] A minority of

---

[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

[Footnote continued on next page]

courts, however, determined that the weighing of competing inferences at the pleading stage was inappropriate when all factual allegations should be construed in favor of the plaintiff. In 2006, the Seventh Circuit pushed the minority view squarely into the spotlight in *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*,[38] which prompted the Supreme Court to grant certiorari. On June 21, 2007, the Supreme Court issued its much anticipated decision in *Tellabs*, which addressed the standard for pleading a "strong inference" under the PSLRA, and which held that an inference of scienter is only "strong" if it is at least as strong as opposing inferences. Therefore, *Tellabs* is the most important securities case of the year with respect to the pleading of scienter.

A. Tellabs - The Supreme Court Weighs In On "Strong Inference"

In an 8-1 decision (Stevens dissenting), the Supreme Court reversed the Seventh Circuit decision on pleading standards, and affirmed that Congress intended to establish a rigorous pleading standard for claims under the PSLRA.[39] Going forward, Plaintiffs will have to provide fairly specific allegations of fraudulent intent in order to avoid dismissal of a complaint alleging securities fraud. In the majority opinion authored by Justice Ginsberg, the Court held that for an inference of scienter to be strong, it "must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of

---

[Footnote continued from previous page]
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] 437 F.3d 588 (7th Cir. 2006).

[39] *Tellabs, Inc. v. Makor Issues & Rights, Ltd*., No. 06-484 551 U.S. __, 2007 U.S. LEXIS 8270 (June 21, 2007).

nonfraudulent intent."[40] Accordingly, to determine if a complaint's scienter allegations are sufficient, a court must "engage in a comparative evaluation; it must consider not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged."[41]

In *Tellabs*, shareholders alleged that Richard Notebaert, Tellabs' CEO and president, engaged in a scheme to deceive investors about the true value of Tellabs' stock.[42] According to the complaint, Notebaert misled investors, *inter alia,* by (1) continuing to assert that demand for the company's product was growing, when in fact demand was waning; (2) making false representations about the company's financial results; and (3) overstating revenue projections.[43] Based on these statements, shareholders claimed that Tellabs stock was artificially inflated.[44]

In dismissing plaintiffs' complaint, the district court held that while the plaintiffs had sufficiently pled that Notebaert's statements were misleading, they had insufficiently alleged that he acted with scienter.[45] On appeal, the Seventh Circuit disagreed and found that the complaint adequately alleged scienter, holding a complaint will survive "if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent."[46] In adopting this standard, the Seventh Circuit explicitly rejected the Sixth Circuit's approach, which

---

[40] *Id.* at *3.
[41] *Id.* at *11.
[42] *Id.* at *12.
[43] *Id.* at *13-14..
[44] *Id.*
[45] *Id.* at *16.
[46] *Id.* at *16-17.

involved an assessment of competing inferences.[47] Contrary to the Sixth Circuit and a majority of other circuits, the Seventh Circuit held that competing inferences should not be considered, noting that such an assessment could impinge upon plaintiffs' Seventh Amendment Rights.[48]

The Supreme Court granted certiorari to resolve the circuit split as to whether, and to what extent, a court must consider competing inferences in determining whether a securities fraud complaint gives rise to a strong inference of scienter.[49] The Court described its task as "to prescribe a workable construction of the 'strong inference' standard, a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."[50] Accordingly, the Court established the following three part test:

"*First*, faced with a Rule 12(b)(6) motion to dismiss a §10(b) action, courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true."[51] "*Second*, courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss."[52] This is an inquiry into "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual

---

[47] *Id.* at *17.
[48] *Id.*
[49] *Id.* at *17-18.
[50] *Id.* at *26.
[51] *Id.* (citing *Leatherman* v. *Tarrant County Narcotics Intelligence and Coordination Unit*, 507 U. S. 163, 164 (1993).
[52] *Id.*at *27.

allegation, scrutinized in isolation, meets that standard."[53] "*Third*, in determining whether the pleaded facts give rise to a "strong" inference of scienter, the court must take into account plausible opposing inferences," an inquiry which the Seventh Circuit declined to make.[54]

In order to flesh out the above the three part test, the Court provided the following additional guidance:

> The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite 'strong inference' of scienter, a court must consider plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff. . . . [T]he inference of scienter must be more than merely 'reasonable' or 'permissible'—it must be cogent and compelling, thus strong in light of other explanations. A complaint will survive, we hold, only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.[55]

In sum, the Supreme Court instructed courts to accept the allegations in the complaint as true, and then ask: would a reasonable person deem the inference of scienter is *at least* as

---

[53] *Id.**27-28 (citing *e.g.*, *Abrams* v. *Baker Hughes Inc.*, 292 F. 3d 424, 431 (CA5 2002); *Gompper* v. *VISX*, *Inc.*, 298 F. 3d 893, 897 (CA9 2002)); Brief for United States as *Amicus Curiae* 25.

[54] *Id.*

[55] *Id.* at *29-30.

strong as any competing or opposing inference? If the answer is no, the inference is not "strong" under the PSLRA.

The Court rejected the Seventh Circuit's concern that the weighing of competing inferences may usurp the jury's role as a fact finder.[56] "A court's comparative assessment of plausible inferences, while constantly assuming the plaintiff's allegations to be true, we think it plain, does not impinge upon the Seventh Amendment right to jury trial."[57] The Court noted that Congress has the power to prescribe what must be pleaded to state the claim, just as it has power to determine what must be proved to prevail on the merits.[58] "No decision of this Court questions that authority in general, or suggests, in particular, that the Seventh Amendment inhibits Congress from establishing whatever pleading requirements it finds appropriate for federal statutory claims."[59] Further, the court dispelled the argument that under its prescribed "strong inference" standard, a plaintiff would be forced to plead more than would be required to prove at trial. "[W]e hold today, [that a plaintiff] must plead facts rendering an inference of scienter *at least as likely as* any plausible opposing inference. At trial, she must then prove her case by a 'preponderance of the evidence.'"[60] Therefore, no conflict exists.

Both Justice Scalia and Justice Alito wrote concurring opinions expressing that, if anything, the majority's test is

---

[56] *Id.* at *34.
[57] *Id.*
[58] *Id.* at *35.
[59] *Id* (citing Cf. *Swierkiewicz* v. *Sorema N. A.*, 534 U. S. 506, 512-513 (2002); *Leatherman*, 507 U. S., at 168 (both recognizing that heightened pleading requirements can be established by Federal Rule, citing Fed. Rule Civ. Proc. 9(b), which requires that fraud or mistake be pleaded with particularity)).
[60] *Id.* at *37-38.

too lenient. They argued that for an inference of scienter to be strong, it must be *more* plausible than an inference of innocence, not merely *as* strong.[61] Justice Scalia made the colorful analogy that "[i]f a jade falcon were stolen from a room to which only A and B had access, could it *possibly* be said there was a 'strong inference' that B was the thief? I think not, and I therefore think that the Court's test must fail.[62]

In lone dissent, Justice Stevens argued for a probable cause type test such as that used in criminal arrests. "There are times when an inference can easily be deemed strong without any need to weigh competing inferences. For example, if a known drug dealer exits a building immediately after a confirmed drug transaction, carrying a suspicious looking package, a judge could draw a strong inference that the individual was involved in the aforementioned drug transaction without debating whether the suspect might have been leaving the building at that exact time for another unrelated reason."[63]

Tellabs marks another recent blow to plaintiffs hoping to sustain a weakly pleaded securities claim. In May, 2007, the Supreme Court issued an opinion in *Bell Atlantic Corp. v. Twombly*,[64] rejecting the 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."[65] The Court held that the "no set of facts" language "has earned its retirement" and "is

---

[61] *Id.* at *39; *46.
[62] *Id.* at *39.
[63] *Id.* at *51.
[64]**[No. 05-1126, 530 U.S. __],** 2007 U.S. LEXIS 5901 (May 21, 2007),
[65] 2007 U.S. LEXIS 5901, at *31.

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."[66] Under the proper standard, the Court held that a plaintiff must plead facts "plausibly suggesting (not merely consistent with)" unlawful conduct,[67] and dismissal is required where "nothing contained in the complaint invests either the action or inaction alleged with a plausible suggestion of [unlawfulness]."[68]

While the Court's ruling in *Tellabs* is viewed as a victory for the securities defense bar, the Court did not go as far as it could have gone.[69] Given the pro-business predisposition of today's Court, as well as the plain language of the statute, the Court could have easily adopted the view espoused by the concurring Justices that an inference is only strong, if it is *more* plausible than competing inferences. In any case, *Tellabs* strengthens the pleading standard set forth by Congress in the PSLRA, and creates a uniformly high bar for pleading scienter in securities fraud cases.

---

[66] *Id.* at *35 (emphasis added).
[67] *Id.* at *25.
[68] *Id.* at *39.
[69] Milberg Weiss & Bershad LLP, lead counsel for the plaintiff investors in the Tellabs case, issued a press release on June 21, 2007 stating: "Investors everywhere should be very comfortable with the Supreme Court's decision. We believe that the decision will not have an adverse impact on the prosecution of securities fraud cases, and that the Tellabs case itself will be allowed to continue when it is sent back to the lower court." *See* http://www.quote.com/qc/news/story.aspx?symbols=PRNEWS:100&story=200706212106_PRN_94880799.

B. Other Cases of Interest on Pleading Scienter

The First Circuit. In *Ezra Charitable Trust v. Tyco Int'l, LTD*,[70] 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.'"[71] Further, the Court noted that all competing inferences must be considered in order to find a strong inference of scienter.[72] 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.[73] "Under all the facts and circumstances alleged, the second inference is at least as strong as the first and thus dooms plaintiffs' claims."[74] Thus, 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

[70] 466 F.3d 1, 6 (1st Cir. 2006).
[71] *Id.* at 6 (quoting *In re Cabletron Systems, Inc. Securities Litigation*, 311 F.3d 11, 38 (1st Cir. 2002)).
[72] *See Ezra*, 466 F.3d at 11.
[73] 466 F.3d at 9-11.
[74] *Id*. at 11.

motive and opportunity, without something more, fail to satisfy the PSLRA."[75] 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.[76]

The Third Circuit. In *Berckeley Inv. Group, Ltd. v. Colkitt*,[77] 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.'"[78] 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."[79] 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.[80]

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

---

[75] *Id.* at 10 (citing *Cabletron*, F.3d at 39).
[76] *Ezra*, 466 F.3d at 12.
[77] 455 F.3d 195, 216 (3rd Cir. 2006).
[78] *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)).
[79] *Id.* at 219.
[80] *Id.* at 222.

aware of it."[81] This standard corresponds exactly to the "extreme recklessness" standard applied in the Fourth and Fifth Circuits.[82]

The Fourth Circuit. In *Teachers Ret. Syst. v. Hunter*,[83] the Fourth Circuit continued to apply the "recklessness" standard as an alternative to a showing of intentional misconduct.[84] In affirming the district court's dismissal of the complaint for 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."[85] 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.[86]

---

[81] *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)).

[82] *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).

[83] 477 F.3d 162, 184 (4th Cir. 2007).

[84] 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 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.

[85] *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)).

[86] *Id.*

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."[87]

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[.]'"[88] 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*,[89] 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*."[90] 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.[91] 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

---

87 *Id.*

88 *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)).

89 440 F.3d 278, 287 (5th Cir. 2006).

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

91 *Id.* at 289-90.

types of allegations do "*not* satisfy the scienter requirement."[92]

The Sixth Circuit. In *Brown v. Earthboard Sports*,[93] a financial advisor allegedly passed on inside information to a client, unaware that the information was false. Both the advisor and his client bought stock on the basis of the tip, and both lost money as a result.[94] The district court granted summary judgment for the defendants finding the 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.[95] 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

---

[92] *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).

[93] *Brown*, 481 F.3d at 905.

[94] *Id.*

[95] *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 . . . .").

> 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.[96]

The Seventh Circuit. *In Tricontinental Indus. v. PricewaterhouseCoopers, LLP*,[97] 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 . . . ."[98].

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.[99] This relatively stringent standard

---

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

[97] 475 F.3d 824, 841 (7th Cir. 2007).

[98] *Id.* at 842.

[99] *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).

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,*[100]

The Tenth Circuit. In *McNamara v. Pre-Paid Legal Servs.*,[101] 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*.[102] 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.[103] "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."[104] 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.[105] 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").

---

[100] 183 F.3d 970, 979 (9th Cir. 1999).
[101] 189 Fed. Appx. 702, 710-11 (10th Cir. 2006) (unpublished).
[102] 264 F.3d 1245, 1257 (10th Cir. 2001).
[103] *Id.* at 713.
[104] *Id.*
[105] *Id.*

The Eleventh Circuit. In *Garfield v. NDC Health Corp.*,[106] 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,*[107] 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."[108] This standard is met when the defendant ignores glaring red flags, none of which were evident in the facts of *Garfield*.[109] 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.[110]

C. "Group Pleading" of Scienter

The group pleading doctrine enables Plaintiffs to charge officers and directors with collective responsibility for statements made in information published as a group such as press releases, registration statements, annual reports, prospectuses. Increasingly, courts have determined that the

[106] 466 F.3d 1255, 1264 (11th Cir. 2006).
[107] *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).
[108] *Id.* at 1266.
[109] *Id.*
[110] *See id.* at 1266.

PSLRA pleading requirements are so contrary to the group pleading doctrine that the doctrine has been essentially abolished with the passage of the PSLRA. "[T]he PSLRA requires the plaintiffs to distinguish among those they sue and enlighten *each defendant* as to his or her particular part in the alleged fraud. As such, corporate officers may not be held responsible for unattributed corporate statements solely on the basis of their titles, even if their general level of day-to-day involvement in the corporation's affairs is pleaded." *Southland Sec. Corp. v. INSpire Ins. Solutions. Inc.*,[111] For such statements to be charged to an individual defendant, the plaintiff must provide "specific factual allegations [that] link the individual to the statement at issue." *Id.*

In the past year, the majority of courts continued to hold that the group pleading doctrine is contrary to the PSLRA pleading standard. However, a number of courts have determined that group pleading is still viable if the plaintiff has alleged facts indicating that the defendant was a corporate insider or affiliate with direct involvement in the day-to-day affairs of the company.

Second Circuit. In *In re Refco, Inc. Sec. Litig*.,[112] various defendants moved for dismissal in a large securities class action arising from the collapse of Refco Inc., a provider of brokerage and clearing services in the international derivatives, currency and futures markets.[113] Plaintiffs brought claims under the Securities Act of 1933 and the Exchange Act of 1934 alleging that Refco's management designed a scheme to hide certain risky loans that were made without adequately assessing a customers

[111] 365 F.3d 353, 365 (5th Cir. 2004)(internal quotations omitted; emphasis in original).
[112] 2007 U.S. Dist. LEXIS 31969 (S.D.N.Y. 2007).
[113] *Id.* at * 3.

credit worthiness.[114] Plaintiffs' claims against the officer defendants were predicated on Section 10(b) and relied on group pleading.[115] Following the Fifth Circuit, the court stated that the PSLRA "does not explicitly abolish the [group pleading] doctrine" because there is no "apparent contradiction between the idea that each defendant's role must be pled with particularity and the fact that corporate officers may work as a group to produce particular document."[116] Thus, "[a]lleging direct involvement in the company's everyday business is critical to support the presumption [of group pleading]."[117] The court found that the complaint adequately alleged that each of the officers "prepared and approved" the allegedly fraudulent documents, and therefore the allegations in the complaint were sufficient to survive a motion to dismiss.

In regards to the Audit Committee defendants, the Plaintiffs also relied on group pleading, and alleged that the audit committee members had extensive access to Refco's internal information, were responsible for overseeing the integrity of financial statements, and approved financial statement during the relevant periods.[118] The court found these allegations sufficient under the group pleading doctrine on the grounds that these defendants had access to information akin to a corporate insider.[119] Accordingly, the court accepted the group plead allegations against the officers and Audit Committee defendants and denied the motion to dismiss in regards to these defendants.

---

[114] *Id.* at *3-4.
[115] *Id.* at *74
[116] *Id.* at *74
[117] *Id.* at *75.
[118] *Id* at 77-78.
[119] *Id.*

In *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC*[120] investors sought to recover losses under Section 10(b) of the Exchange Act following the liquidation of two hedge funds. The plaintiffs alleged the director defendants did not conduct a thorough valuation of the funds and failed "to disclose irregularities" of the fund to investors.[121] Plaintiffs relied on the group pleading doctrine to avoid having to plead the particular role of each director in the dissemination of the allegedly misleading misstatements.[122] The court granted Defendants' motion to dismiss for failure to plead scienter. "[P]laintiffs' attempts to avail themselves of [the group pleading doctrine] are defeated by their failure to identify the "group" that published the documents.[123]

In *In re Marsh & McLennan Cos. Sec. Litig.*,[124] plaintiffs brought a class action against an insurance broker and its current and former officers and directors alleging violations of the Exchange Act and the Securities Act. In reliance on the group pleading doctrine, Plaintiffs alleged that defendants made misstatements and omissions regarding the insurance broker's business generally, as well as misrepresentations regarding its practices in the collection of commissions.[125] In response, the defendants' argued that the group pleading doctrine did not survive the enactment of the PSLRA and therefore Plaintiffs' section 10(b) claim must fail. The court noted "[t]he majority rule in this district is that the group pleading doctrine has survived the PSLRA," however, a plaintiff may invoke the group pleading doctrine

---

[120] 446 F. Supp. 2d 163, 203 (S.D.N.Y. 2006).
[121] *Id.* at 173.
[122] *Id.* at 184.
[123] *Id.* at 186.
[124] 2006 U.S. Dist. LEXIS 49525 (S.D.N.Y. July 19, 2006).
[125] *Id.* at *7.

"only if the plaintiff has alleged facts indicating that the defendant was a corporate insider or affiliate with direct involvement in the daily affairs of the company."[126] Because the court held that plaintiffs failed "to allege with particularity that the Independent Directors were sufficiently involved in the day-to-day operations," the court rejected plaintiffs reliance on the group pleading doctrine.[127]

Third Circuit. In *Payne v. DeLuca,*[128] plaintiff investors alleged that the defendants issued public statements which failed to disclose the magnitude the company's financial difficulties, and perpetrated a fraudulent scheme to artificially inflate the price of corporation shares. Plaintiffs argued that "each Individual Defendant was 'involved in drafting, preparation and/or dissemination of the various public, shareholder and investor reports or other communications' or was 'able to and did control the content of the various SEC filings, press releases and other public statements pertaining to the Company.'"[129] The court found these types of generalized claims insufficient and held that under the PSLRA, allegations based upon group pleading cannot establish a strong inference of scienter.[130]

The Fourth Circuit. In *In re Mutual Funds Inv. Litig.*,[131] plaintiffs relied on the group pleading doctrine and alleged that the corporation's outside Trustees had access to relevant information but "fail[ed] to detect and put an end to the unlawful practices."[132] Despite the fact that the court had

---

[126] *Id.* at 66
[127] *Id.*
[128] 433 F. Supp. 2d 547 (W.D. Pa. 2006).
[129] *Id* at 570.
[130] *Id.*
[131] 437 F. Supp. 2d 444 (D. Md. 2006).
[132] *Id.* at 447.

previously rejected the group pleading doctrine, the plaintiffs argued that the doctrine should be extended to include outside directors who, "by virtue of their status or a special relationship with the corporation," have access to information more akin to a corporate insider.[133] However, the court found that even under this standard, plaintiffs failed to show the outside directors had such a relationship with the corporation.[134] Plaintiffs provided no evidence that the outside trustees directed, condoned, or had knowledge of the market timing practices, and plaintiffs instead relied solely on the allegation that the outside trustees had access to relevant information but failed to detect and put an end to the unlawful practices.[135]

The Fifth Circuit. In *Fin. Acquisition Partners LP v. Blackwell*,[136] plaintiffs appealed the dismissal of their second amended complaint. Plaintiffs' claims arose from the bankruptcy of Amresco Inc. Plaintiffs brought the action against former Amresco officers, alleging misrepresentations in financial statements. The allegations involved false financial statements, and statements made by officers in meetings with shareholder concerning Amresco's ability to obtain financing.[137] The court held that the district court correctly rejected the group pleading doctrine and that the plaintiffs failed to specify which individual defendants made the statements.[138] The court reaffirmed its holding in *Southland Sec. Corp. v. INSpire Ins. Solutions. Inc.*,[139] and

---

[133] *Id.* at 446.
[134] *Id.*
[135] *Id.* at 447.
[136] 440 F.3d 278 (5th Cir. 2006).
[137] *Id.* at 283.
[138] *Id.*
[139] 365 F.3d 353 (5th Cir. 2004) (finding the "group pleading" doctrine conflicts with the scienter requirement of the PSLRA),

held that to the extent existing authority conflicts with *Southland*, *Southland* controls.

In *In re OCA, Inc. Sec. & Derivative Litig.*,[140] a class action brought under section l0(b) of the Exchange Act, Plaintiffs alleged that defendants misled investors by concealing material deficiencies in the company's internal controls and overstating the company's reported receivables.[141] In reliance on *Southland Sec. Corp. v. INSpire Ins. Solutions. Inc.*,[142] the court found that the plaintiff failed "to specifically link a number of the alleged false statements to any individual."[143] Unable to rely on the group pleading doctrine, the court held that the defendants "cannot be held liable for any statements that plaintiff has not specifically tied to them."[144]

The Sixth Circuit. In *In re Nat'l Century Fin. Enters., Inv. Litig.*,[145] Plaintiffs brought claims under Section 10(b) of the Exchange act alleging that National Century engaged in a massive scheme to defraud investors, and that the Outside Directors knew of the fraud and helped conceal it.[146] Plaintiffs further alleged that the Outside Directors were responsible for misrepresentations contained in the offering materials issued to induce investors to purchase notes, and that the Outside Directors knew that the company was violating note agreements but failed to act to protect the interests of investors.[147] The complaint used group pleading

---

[140] 2006 WL 3747560 (E.D. La. Dec. 14, 2006).
[141] *Id.* at *7.
[142] 365 F.3d 353 (5th Cir. 2004).
[143] *Id.* at *12.
[144] *Id.*
[145] 2007 U.S. Dist. LEXIS 33394 (S.D. Ohio 2007).
[146] *Id.* at *12-13.
[147] *Id.* at *13.

in an attempt to hold the outside directors liable for misrepresentations in offering materials. In dismissing the 10(b) claim against the defendants, the court held that the plaintiffs' reliance on group pleading was improper.[148] Noting the split of authority among the circuit courts regarding whether group pleading survived the passage of the PSLRA, the court stated that "even where group pleading has been permitted, only those individuals with direct involvement in the everyday business of the company may be presumed to be responsible for statements made in group-published documents."[149] To meet this standard, Plaintiffs argued that the Outside Directors should be liable because they had insider-type access to information.[150] The court rejected this argument, finding that even applying this standard, the allegations were insufficient to attribute the allegedly misleading statements to the outside directors.[151]

The Seventh Circuit. In *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*,[152] plaintiffs alleged that the company and its executive officers engaged in a scheme to deceive investors regarding the true value of the company stock. In its analysis regarding the group pleading doctrine, the court first noted the split in the circuits as to whether the group pleading doctrine survived the PSLRA, stating: "[t]he answer ... lies in the language of the statute" which requires the complaint to "state with particularity facts giving rise to a strong inference that *the defendant* acted with the required state of mind."[153] While not specifically deciding the issue for the Seventh Circuit, the court held that when bringing suit

[148] *Id.* at 32.
[149] *Id.* at *23.
[150] *Id.* at 29.
[151] *Id.* at 30.
[152] 437 F.3d 588, 591 (7th Cir. 2006).
[153] *Id.* at 602.

against multiple defendants, plaintiffs must create a strong inference of scienter with respect to each individual defendant.[154]

The Ninth Circuit. In *In re NextCard, Inc. Sec. Litig.*,[155] the plaintiffs' alleged that NextCard and its officers and directors artificially inflated the company's financial numbers by, *inter alia,* engaging in fraudulent accounting methods such as overstating its income and understating its losses.

In addressing Plaintiff's claims based on group pleading, the court recognized that it is "an open question in [the Ninth Circuit] whether the group published pleading doctrine survive[d] the PSLRA." However, the court adopted the reasoning of those courts that have determined that the doctrine did not survive the PSLRA. Citing the Fifth Circuit in *Sec. Corp. v. INSpire Ins. Solutions, Inc*.,[156] the court found it "totally inconsistent with the particularity requirements of the PSLRA to hold corporate officers 'responsible for unattributed corporate statements solely on the basis of their titles, even if their general level of day-to-day involvement in the corporation's affairs is pleaded.'"[157]

---

[154] *Id*. at 603.
[155] 2006 WL 708663 (N.D. Cal. Mar. 20, 2006).
[156] 365 F.3d 353, 365 (5th Cir. 2004).
[157] *Id*. at *3.

D. Use of Confidential Witnesses in Federal Securities Litigation

1. Confidential Witnesses and "Pleading with Particularity"

In the typical (i.e. non-securities) case, plaintiffs are under no obligation to disclose the fact that information contained in their complaint may have been gathered from confidential witnesses. In federal securities cases, however, the PSLRA mandates that when plaintiffs allege that a defendant has made fraudulent statements or omissions, and those allegations are made on *information and belief*, the plaintiff must "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). The purpose of this requirement "is to avoid 'speculation' about defendants' knowledge and intent, because '[i]t is not sufficient for a plaintiff's pleadings to set forth a belief that certain unspecified sources will reveal, after appropriate discovery, facts that will validate her claim.'" *In re McKesson HBOC, Inc. Sec. Litig.*,[158]

This requirement that plaintiffs state with particularity "all facts on which [their] belief is formed" obviously has implications for whether plaintiffs may rely on confidential witnesses in their pleadings. The earliest cases to consider the issue held that the PSLRA prohibits the use of any confidential witnesses, and that all sources of information contained in a complaint must be named. *See, e.g., In re Silicon Graphics, Inc. Sec. Litig.*[159] However, courts now agree that the PSLRA does not prevent the use of

---

[158] 126 F. Supp. 2d 1248, 1270-71 (N.D. Cal. 2000) (quoting *In re Silicon Graphics, Inc. Sec. Litig*., 183 F.3d 970, 985 (9th Cir. 1999)).
[159] 970 F. Supp. 746, 764 (N.D. Cal. 1997); *In re Aetna Inc. Sec. Litig.*, MDL No. 1219, 1999 U.S. Dist. LEXIS 8038, at *12-13 (E.D. Pa. 1999).

confidential witnesses, and that plaintiffs may rely on such witnesses at the pleading stage as long as certain requirements are met.

The majority rule regarding the use of confidential witnesses at the pleading stage was outlined by the Second Circuit in *Novak v. Kasaks*.[160] In *Novak*, the Second Circuit held that "plaintiffs who rely on confidential sources are not always required to name those sources, even when they make allegations on information and belief concerning false or misleading statements . . ."[161] Instead, the court held, plaintiffs may rely on statements attributed to an unnamed witness so long as plaintiffs (1) provide other facts, aside from the statements of confidential witnesses, that provide an adequate basis for believing that the defendant's statements were false (sometimes referred to as "adequate corroborating details"), and (2) describe the confidential witnesses relied upon in the complaint with sufficient particularity to support the probability that a person in the position occupied by the confidential witness would possess the information they

---

[160] 216 F.3d 300, 313 (2d Cir. 2000).
[161] *Id*.

purport to possess.[162] A majority of Circuits have since adopted the *Novak* analysis, or a substantially similar test.[163]

2. Recent Cases Addressing Confidential Witnesses

Several courts have recently considered the use of confidential witnesses under the PSLRA. The analysis in many of these cases has turned on whether the plaintiffs described their confidential sources with sufficient particularity to show that a person in the source's position would actually have access to the information that they claim to have, and there appears to be significant variance among courts on this issue. California district courts, for example, tend to require a very detailed description of a confidential source's role within the company, including a thorough account of his or her job duties. The Southern District of New York, on the other hand, appears willing to accept a

[162] "[W]here plaintiffs rely on confidential personal sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false. Moreover, even if personal sources must be identified, there is no requirement that they be named, provided they are described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged." *Novak*, 216 F.3d at 314. *See also In re Daou Sys. Sec. Litig.*, 411 F.3d 1006, 1015 (9th Cir. 2005) ("Naming sources is unnecessary so long as the sources are described with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged and the complaint contains adequate corroborating details."). *Id.* at 314.

[163] *See, e.g.*, *In re Cabletron Sys., Inc.*, 311 F.3d 11, 29-30 (1st Cir. 2002); *Cal. Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 146-47 (3d Cir. 2004); *ABC Arbitrage Plaintiffs Group v. Serje Tchuruk*, 291 F.3d 336, 351-53 (5th Cir. 2002); *In re K-Tel Int'l Sec. Litig.*, 300 F.3d 881, 890 (8th Cir. 2002); *In re Daou Sys. Sec. Litig.*, 411 F.3d 1006, 1015 (9th Cir. 2005).

more cursory description of a confidential source's "position" within the company.

a. California/Ninth Circuit

District courts in California and the Ninth Circuit have generally interpreted the PSLRA to require a very detailed description of confidential witnesses. Plaintiffs are required to provide specifics regarding a confidential source's functional role within the company; generalities are insufficient. A plaintiff may not, for example, simply state the confidential source's job title. Such a description in insufficient to demonstrate that the source is in a "position" to possess the information alleged. In *In re Dura Pharma., Inc. Sec. Litig.*,[164] the court held that a confidential witness identified simply as a "former Dura Regional Sales Director" did not meet the PSLRA's pleading requirements. The court noted that "there are no allegations regarding the job duties of the former Regional Sales Director or how that individual was privy to the information attributed to him or her."[165]

Similarly, the court in *In re Silicon Image, Inc. Securities Litigation*[166] found plaintiffs' description of their confidential sources insufficient. Plaintiffs relied on three confidential sources in their complaint. The first was described "as having performed 'a variety of senior roles including Director of Marketing and Director of North America Western Sales'," the second was identified as a "Human Resource Generalist," and the third was described as "a 'senior level employee' who 'reported directly' to the

---

[164] 452 F. Supp. 2d 1005, 1029 (S.D. Cal. 2006).
[165] *Id.* at 1030.
[166] No. C-05-456 MMC, 2007 U.S. Dist. LEXIS 16248 (N.D. Cal. Feb. 23, 2007).

Vice President of Operations."[167] In finding that plaintiffs had not sufficiently described the confidential sources, the court noted that plaintiffs had provided "little to no details as to the work performed" by the confidential witnesses.[168] The court contrasted the descriptions in this case with those offered in *Daou*, in which the plaintiffs "'described the [source's] job description and responsibilities,' thus enabling the district court to determine whether [the] source would be 'familiar' with information provided by [the] source."[169]

In *In re SeraCare Life Sciences, Inc. Securities Litigation*,[170] the court found that plaintiffs' description of a confidential witness was insufficiently particularized, despite plaintiffs description of the witness as "a Warehouse Logistics Manager . . . whose responsibilities included shipping and receiving final product and raw materials . . . distributing and tracking production materials, managing inventory, and performing annual inventory audits."

In *In re Tibco Software Securities Litigation*,[171] the court held that plaintiffs had not alleged sufficient facts showing that the confidential witnesses were reliable sources. Among other things, the court noted that plaintiffs did not state the physical location where two of the witnesses

---

[167] *Id*. at *9.
[168] *Id*. at *10.
[169] *Id*.
[170] No. 05-CV-2335-H (CAB), 2007 WL 935583, at *8 (S.D. Cal. March 19, 2007). *See also In re Silicon Storage Tech., Inc. Sec. Litig.*, No. C 05-0295 PJH, 2006 U.S. Dist. LEXIS 14790, at *29-47 (N.D. Cal. 2006) (rejecting plaintiffs' "sketchy description" of confidential sources' job duties, despite rather detailed job descriptions offered by plaintiffs)
[171] No. C 05-2146 SBA, 2006 U.S. Dist. LEXIS 36666 (N.D. Cal. 2006).

worked, and did not make clear to whom the witnesses reported or who reported to them.[172]

The court in *In re Hypercom Corp. Sec. Litig*.[173] held that plaintiffs cannot satisfy the PSLRA's heightened pleading requirements with respect to confidential witnesses by simply providing the job title of the witness, and providing no other detail regarding the witness's job description or responsibilities. With respect to four of the five confidential witnesses relied upon by plaintiffs, the court held that simply identifying the witnesses as "accountants" or "former Accounting Managers," with no other facts regarding the witnesses' job duties and responsibilities, did not provide a basis for establishing the reliability of the their statements.[174] However, despite this holding, the court also found that the description of one confidential witness offered by the plaintiffs *did* comply with the PSLRA, despite the fact that plaintiffs again provided only a job title, with no job description or summary of his duties. The court noted that "[t]he Complaint alleges [the confidential witness's] title, attributes specific allegations to [the witness], *and from his allegations the court can deduce his job description and responsibilities*."[175] It remains unclear why the court chose to make such inferences with respect to only one of the confidential witnesses, particularly when such an inference appears to be in direct conflict with other portions of the court's opinion.

---

[172] *Id*. at *64-67. *See also In re Portal Software, Inc. Sec. Litig.*, No. C-03-5138 VRW, 2006 U.S. Dist. LEXIS 61589, at *21-28 (N.D. Cal. 2006) (holding that plaintiff's description of some confidential witnesses was not sufficiently particularized).

[173] No. CV-05-0455-PHX-NVW, 2006 U.S. Dist. LEXIS 2669, at *17-24 (D. Ariz. 2006).

[174] *Id*. at *19-25.

[175] *Id*. at *19 (emphasis added).

While the issue of exactly how much detail plaintiffs must provide with respect to a confidential witness appears to be largely subjective, and decided by courts on a case-by-case basis, the court in *Limantour v. Cray, Inc*.[176] did outline one bright-line rule with respect to such witnesses. The *Limantour* court held that a plaintiff's failure to provide the dates that a confidential witness was employed with a company constitutes "a fatal flaw," and held that plaintiffs' proffered witnesses did not meet the PSLRA's pleading requirements since no dates of employment were provided.

b. Southern District of New York/Second Circuit

In contrast to the detailed descriptions required by California district courts, courts in the Southern District of New York have generally interpreted the PSLRA to permit much less specific descriptions of confidential witnesses.

In *Montoya v. Mamma.com, Inc*.,[177] for example, the court found that plaintiffs description of a confidential witness as "a product marketing specialist who worked for years in Mamma.com's Montreal office" as sufficient to satisfy the PSLRA's pleading requirements. Similarly, the court in *City of Sterling Heights Police & Fire Retirement Systems v. Abbey National, PLC*,[178] found that plaintiffs' description of a confidential witness as simply "a senior

---

[176] 432 F. Supp. 2d 1129, 1142-43 (W.D. Wash. 2006).

[177] 05 Civ. 2313 (HB), 2006 U.S. Dist. LEXIS 13207, at *19 (S.D.N.Y. 2006).

[178] 423 F. Supp. 2d 348, 358 (S.D.N.Y. 2006). *See also In re Veeco Instruments, Inc. Sec. Litig*., 05 MD 1695 (CM), 2006 U.S. Dist. LEXIS 13226, at *19-21 (S.D.N.Y. 2006) (finding plaintiff's generalized descriptions of confidential witnesses sufficient under PSLRA); *In re EVCI Colleges Holding Corp. Sec. Litig*., 469 F. Supp. 2d 88, 96-97 (S.D.N.Y. 2006) (same).

executive in Wholesale Banking" was sufficient to satisfy the PSLRA.

There are limits, however, to the Southern District of New York's more liberal interpretation of the PSLRA's pleading requirements with respect to confidential witnesses. Plaintiffs may not, for example, rely on the statements of witnesses identified simply as "former employees." *See In re IAC/InterActiveCorp Sec. Litig.*,[179]

c. Other Jurisdictions

In *Brody v. Zix Corp.*,[180] the court held that a defendant could obtain through discovery the names of the confidential witnesses relied on by plaintiffs. Plaintiffs in the case objected to the disclosure of their confidential sources, arguing that (1) the identities of the confidential sources named in the complaint were protected as attorney work product, (2) that such disclosure should not be required based on public policy, and (3) that none of the confidential sources would be used in the future. The court rejected each of these arguments. It first held that Fed. R. Civ. P. 26(a)(1) and 26(b)(1) required disclosure of the witnesses' identities, since such witnesses "unquestionably have knowledge of facts relevant to a claim or defense."[181] With respect to the argument that such disclosure could subject the confidential

---

[179] 04 Civ. 7447 (RJH), 2007 U.S. Dist. LEXIS 20788, at *50 (S.D.N.Y. March 22, 2007). *See also In re Sierra Wireless, Inc. Sec. Litig.*, 05-md-1696 (SHS), 2007 U.S. Dist. LEXIS 28494, at *29-30 (S.D.N.Y. April 18, 2007) (finding insufficient plaintiffs' description of confidential witness as "founder" of a company acquired by the defendant in the past, with no indication of whether witness ever actually worked for the defendant).

[180] No. 3-04-CV-1931-K, 2007 U.S. Dist. LEXIS 38230, at *4 (N.D. Tex. May 25, 2007).

[181] *Id*. at *6, *8.

witnesses to serious consequences, the court replied that "[s]uch a conclusory assertion does not come close to establishing a genuine risk of retaliation."[182] Finally, the court held that whether plaintiffs planned to use their confidential sources beyond the pleading stage was irrelevant, since the confidential sources had information relevant to a claim or defense.[183] The court noted that previous cases holding that plaintiffs were not required to reveal the names of their confidential sources stood only for the proposition that such disclosure was not required for plaintiffs to withstand a motion to dismiss.[184] The cases simply did not address, according to the *Brody* court, whether such information could be obtained through discovery.[185]

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

The other major PSLRA pleading case before the U.S. Supreme Court this year besides *Tellabs* 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.

---

[182] *Id*. at *6-7.
[183] *Id*. at *8.
[184] *Id*. at *7.
[185] *Id.*

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*.[186] 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.[187] 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.[188] *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."[189] 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.[190] Accordingly, cases addressing this issue involve a factual analysis of the alleged conduct with respect to the dividing

---

[186] 511 U.S. 164 (1994).
[187] *Cent. Bank*, 511 U.S. at 177-78.
[188] 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.
[189] *Cent. Bank*, 511 U.S. at 191 (first emphasis added).
[190] *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.").

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 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.*,[191] 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.[192] 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

---

[191] 443 F.3d 987 (8th Cir. 2006), *cert. granted sub nom. Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007),

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

§ 10(b),' included claims under Rule 10b-5(a) and (c)."[193] 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.[194]

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."[195] 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.[196] 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.'"[197]

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

---

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

[194] *See also supra* note 6.

[195] *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)).

[196] *Id.*

[197] *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)).

at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5."[198] The Supreme Court of the United States has granted a petition for writ of certiorari in this decision.[199]

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.*,[200] 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.[201]

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.[202] Homestore also entered into so-called "sham transactions" with other third party vendors, whereby the vendors would

---

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

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

[200] 452 F.3d 1040 (9th Cir. 2006).

[201] *Simpson*, 452 F.3d at 1043-44.

[202] *Id.* at 1044-45.

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.[203] L90 entered into triangular transactions with Homestore that followed the same model as AOL,[204] the only difference being that an officer of AOL allegedly helped design the transactions in question.[205]

Relying on *Cooper v. Pickett*,[206] 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."[207] 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."[208] By adopting this test for a "manipulative or deceptive act" the Ninth Circuit deliberately chose not to 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.[209] 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

---

[203] *Id.* at 1044.
[204] *Id.* at 1045.
[205] *Id.* at 1045 n.1.
[206] 137 F.3d 616 (9th Cir. 1997).
[207] *Id.* at 1048 (quoting *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997)).
[208] *Id.* at 1048 (emphasis added).
[209] *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)).

create liability. Rather, the defendant's *own conduct* within that scheme must have had a deceptive purpose and effect.[210]

The court provided in dicta examples of conduct that meets the "principle purpose and effect" test,[211] and conduct that falls short.[212] 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."[213]

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.[214] 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

---

[210] *Id.* at 1048.

[211] *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).

[212] *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).

[213] *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)).

[214] *Id.* at 1053.

the scheme did not have the principal effect and purpose of creating a false appearance.[215] L90's transactions were not deceptive for similar reasons, bolstered by the fact that L90 did not help design the scheme in question.[216] 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.[217] Accordingly, the court affirmed the dismissal of charges against the defendants, but remanded to allow for the possibility of amendment.

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*.[218] 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).[219] The district court noted that AOL benefited substantially from the scheme supported the conclusion that AOL had a legitimate business interest in the transactions.[220] Similarly, the court found that "[no] new facts … indicate that Cendant's actions created a false appearance in themselves" and thus plaintiffs

---

[215] *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").
[216] *Id.* at 1054; *see also supra* note 24 discussing liability for being primary architects of a scheme.
[217] *Simpson*, 452 F.3d at 1054; *see also supra* note 24, discussing liability for creating sham corporate entities to mislead.
[218] *In re Homestore.com, Inc. Sec. Lit.*, No. CV-01-11115-RSWL, slip op. (C.D. Cal. Dec. 19, 2006).
[219] *Id.* at 7.
[220] *Id.* at 5.

could not allege Cendant's use of a manipulative or deceptive device.[221] 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."[222] Thus, the district court allowed a second amended complaint to be filed with respect to L90.[223] The district court order is on appeal to the Ninth Circuit.[224]

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

In *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*,[225] 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."[226]

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."[227] The court also found that while Enron

---

[221] *Id.* at 10.
[222] *Id.* at 11.
[223] *Id.* at 12.
[224] *See CalSTRS v. Tafeen*, No. 07-55107 (9th Cir. Jan. 25, 2007).
[225] 482 F.3d 372 (5th Cir. 2007).
[226] *Regents of the Univ. of Cal.*, 482 F.3d at 377.
[227] *Id.* at 388 (quoting *In re Charter Commc'ns*, 443 F.3d at 990). The court emphasized that when based on omissions rather than

[Footnote continued on next page]

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)."[228]

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."[229] Based on this definition, the court concluded that plaintiffs failed to allege any conduct that would constitute a manipulative device.[230] 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."[231] 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."[232] Both courts concluded that

---

[Footnote continued from previous page]
misrepresentations, "'deception' … requires that a defendant fail to satisfy a duty to disclose material information to a plaintiff." *Id.* at 384.

228 *Id.* at 390.

229 *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.

230 *Regents of the Univ. of Cal.*, 482 F.3d at 392.

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

232 *Id.*

"[d]ecisions of this magnitude should be made by Congress."[233]

B. Reliance or "Transaction Causation"

1. Ninth Circuit

In *Simpson v. AOL Time Warner, Inc.*,[234] 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.[235]

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."[236] 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."[237] The court reasoned that "a scheme to defraud would not be

---

[233] *Id.* (quoting *In re Charter Commc'ns*, 443 F.3d at 992-93).
[234] 452 F.3d 1040 (9th Cir. 2006). For a summary of the facts of this case, *see* Part II.A.2.
[235] *See supra* note 22 and accompanying text.
[236] *Simpson*, 452 F.3d at 1051. This is typically described as a "fraud-on-the-market" theory.
[237] *Id.* (emphasis added) (citing *In re ZZZZ Best Sec. Litig.*, 864 F.Supp. 960, 973 (C.D. Cal. 1994)).

complete until the fraudulent information was introduced to the market,"[238] and it is thus appropriate to presume, "absent persuasive conflicting evidence," reliance on misstatements resulting from defendant's scheme.[239]

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*.[240] 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.[241] Without a class-wide presumption of reliance, that element would have to be proven individually, defeating class certification.[242]

---

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

[239] *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.").

[240] 482 F.3d 372 (5th Cir. 2007). For a summary of the facts of this case, *see* Part II.A.3.

[241] 482 F.3d at 377.

[242] *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)).

First, the court considered the availability of the *Affiliated Ute* presumption of reliance based on omission,[243] and concluded that the presumption requires that the defendant owe plaintiff a duty of disclosure.[244] Finding that the defendant banks were not fiduciaries and "owed no duty to plaintiffs other than the general duty … not to break the law,"[245] the court concluded that plaintiffs were unable to rely on a presumption of reliance for any omission to disclose the allegedly fraudulent activity.[246]

The court next considered the availability of a "fraud-on-the-market" presumption of reliance,[247] 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."[248] 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.[249] The court explained that "[p]resuming plaintiffs' allegations to 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."[250] Because Section 10(b) does not give rise to aiding and abetting liability, the court held that plaintiffs could not rely

---

[243] *See Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (presumptive reliance for improper omissions).
[244] *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)).
[245] *Id.* at 384-85.
[246] *Id.* at 384.
[247] *See Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (fraud-on-the-market theory of reliance under certain conditions).
[248] *Regents of the Univ. of Cal.*, 482 F.3d at 385-86.
[249] *See id.* at 390.
[250] *Id*. at 386.

on the fraud on the market hypothesis to invoke a presumption of reliance *against the bank defendants*.[251] 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.[252]

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.[253]

C. Other Decisions of Interest

1. Second Circuit – Accountant's Duty to Correct

In *Overton v. Todman & Co., CPAs, P.C.*,[254] 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

---

[251] *Id*. at 390.
[252] *Id*.
[253] *Id*. at 392.
[254] 478 F.3d 479 (2d Cir. 2007).

accepted auditing principles."[255] 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",[256] 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.[257] Shortly thereafter, DBI ceased operations as a result of its financial liabilities.[258]

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*.[259] 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."[260] 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:

---

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

[256] 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.

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

[258] *Id.* at 482.

[259] *Id.* at 483.

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

> (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.[261]

The Court was careful, however, to qualify that its holding required an accountant to merely *correct* prior certified statements, not to update them.[262] 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.[263] The court specifically reserved the question of what circumstances might give rise to an accountant's duty to update,[264] and further limited its holding to require that an

---

[261] *Id.* at 486-87. For a list of "all the other requirements for liability," *see supra* note 6.
[262] *Overton*, 478 F.3d at 487.
[263] *Id.*
[264] *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).

accountant correct "only those particular statements set forth in its opinion and/or the certified financial statements."[265]

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*,[266] dismissing claims against 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."[267] The result of these transactions and securities sales was "to shift $107 million of Fannie Mae's earnings into future years."[268] 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.[269] 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]

---

[265] *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)).

[266] No. MDL-1668, Consol. Civ. Action 04-1639, 2007 U.S. Dist. LEXIS 33939 (D.D.C. May 8, 2007),

[267] *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).

[268] *Id.* at *17.

[269] *Id.* at *16.

purposes."[270] Lastly, Goldman Sachs performed "unspecified functions as 'underwriter/dealer'" when the REMIC interests were being sold.[271]

The district court applied the standard for "manipulative or deceptive" adopted by the Fifth and Eighth Circuits,[272] 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.[273] 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.[274] 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

---

[270] *Id.* at *16, *17 n.2.
[271] *Id.* at *16.
[272] *Id.* at *20. *See also supra* notes 10, 12, 39, 41, and accompanying text; *infra* text accompanying note 69.
[273] *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.
[274] *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)).

Supreme Court's ruling in *Central Bank*," and rejected the Ninth Circuit's "more liberal standard."[275]

V. CLASS CERTIFICATION IN FEDERAL SECURITIES LITIGATION

A. Overview

Class certification in federal securities actions, as in other federal class actions, is governed by Fed. R. Civ. P. 23 and the case law interpreting that rule.[276] To certify a class, a court must find that the proposed class meets all of the requirements of Rule 23(a):

> (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately represent the interests of the class.

These requirements—numerosity, commonality, typicality, and adequacy of representations—present a relatively low hurdle to class certification.

---

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

[276] The Class Action Fairness Act of 2005 (CAFA), effective February 18, 2005, was enacted as an attempt to reform perceived abuses of the class action system. Pub. L. No. 109-2, 119 Stat. 4 (2005). That statute increased federal jurisdiction over class actions and allows for removal where traditional diversity jurisdiction and amount-in-controversy requirements are not met. 28 U.S.C. § 1332(d)(2); *see also Knudsen v. Liberty Mut. Ins. Co*., 411 F.3d 805 (7th Cir. 2005). CAFA also amends Rule 23 to require specific disclosures to be made to certain state or federal officials regarding proposed settlement agreements. 28 U.S.C. § 1715.

Rule 23(b) also requires that one of the following conditions be present: (1) risk that separate actions would result in inconsistent or incompatible standards of conduct for the party opposing the class (encompassing cases where the defendant is obliged by law or practical necessity to treat class members alike) or that one adjudication would, as a practical matter, be dispositive of other actions; (2) separate actions would be dispositive of the interest of others or substantially impede the ability of others to protect their interests (primarily limited fund questions); (3) "the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole" (generally applies to civil rights or employment discrimination cases); or (4) "questions of law or fact common to the members of the class *predominate* over any questions affecting only individual members, and that a class action is *superior* to other available methods for the fair and efficient adjudication of the controversy."[277]

Virtually all securities class actions, however rely on Rule 23(b)(3), the predominance and superiority requirement, which is "far more demanding" than Rule 23(a)'s commonality requirement and "tests whether proposed classes are sufficiently cohesive to warrant adjudication by representation."[278] A non-exclusive list of factors that a court should consider in determining whether the predominance and superiority requirements is set out in the Rule:

> (A) the interest of members of the class in individually controlling the prosecution or defense

[277] *See generally* Fed. R. Civ. Proc. 23(b) & advisory committee's note (emphasis added).
[278] *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 623-24 (1997).

> of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

Courts remain free to consider other factors relevant to class certification in a particular case.[279]

The Private Securities Litigation Reform Act of 1995 increased the requirements to gain class certification. Under the PSLRA, a plaintiff seeking to represent a class must file, with the complaint, a sworn certification stating, among other things, that the plaintiff is not acting at the behest of counsel, is familiar with the subject matter of the complaint, and has authorized filing of the action.[280] The court is required to appoint a lead plaintiff based on the rebuttable presumption that the "most adequate plaintiff" filed the complaint or moved to be appointed lead plaintiff, has the largest financial stake in the relief sought, and otherwise satisfies the requirements of Rule 23.[281] A result of these changes has been more scrutiny as to whether class representatives are able to take an active role, control the litigation, and protect the interests of absent class members.[282]

---

[279] *Id.* at 615-16.

[280] 15 U.S.C. § 78u-4(a)(2)(A).

[281] 15 U.S.C. § 78u-4(a)(3)(B)(i)-(iii).

[282] *See, e.g.*, *Berger v. Compaq Computer Corp*., 257 F.3d 475, 480-81 (5th Cir. 2001) (reversing class certification because the adequacy of class representatives was presumed and an impermissibly lax standard was applied); *but see Herrgott v. United States Dist. Ct. for N. Dist. Cal. (In re Cavanaugh)*, 306 F.3d 726, 736-37 (9th Cir. 2002) (refusing to follow Berger and stating that "neither the Fifth Circuit nor the SEC have

[Footnote continued on next page]

Historically, courts have interpreted Rule 23 liberally and numerous courts have observed that securities litigation is well-suited for class treatment, because the proposed plaintiff class often consists of thousands or even millions of securities holders who each have only a modest stake in the litigation.[283] More recently, however, courts have recognized the serious impact that class certification may have on defendants, who may be forced to settle cases certified as class actions because of the expense of litigation and the specter of catastrophic damages.[284] As a result, a number of more recent decisions have emphasized that trial courts should conduct a rigorous analysis of the applicable class-certification requirements and take a "close look" at the evidence supporting class certification.[285]

B. Recent Class Certification Issues

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 their decisions, two issues in particular have received significant attention: the merits inquiry and the "fraud-on-the-market" doctrine.[286] In connection with considering that doctrine, recent decisions have also discussed what the efficient market hypothesis

---

[Footnote continued from previous page]
pointed to any language in the [PSLRA] that…'raises the adequacy threshold'").

[283] *See, e.g.*, *Eisenberg v. Gagnon*, 766 F.2d 770 (3d Cir. 1985); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975).

[284] *See, e.g.*, *Chamberlan v. Ford Motor Co.*, 402 F.3d 952 (9th Cir. 2005); *Unger v. Amedisys, Inc.*, 401 F.3d 316 (5th Cir. 2005).

[285] *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591 (1997); *Unger*, 401 F.3d 316.

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

means for the purposes of determining how quickly new information is impounded into a stock's price.

1. Extent of the Merits Inquiry When Evaluating Class Certification

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"[287] and should be "tailored to facts emerging in discovery."[288] 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."[289] In contrast, the view that most circuit courts have adopted allows for a more rigorous analysis of certification issues.[290] This view recognizes the magnitude of the certification decision. Indeed, "class certification is often practically dispositive" of costly, high-stakes litigation.

---

287 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."

288 *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 2007 WL 1430225, No. 05-10791 at *11 (5th Cir. May 16, 2007).

289 *Id.* at *4.

290 *See, e.g.*, *Eisenberg v. Gagnon*, 766 F.2d 770, 775 (3d Cir. 1985); *Blackie v. Barrack*, 524 F.2d 891, 903 (9th Cir. 1975); *Blair v. Equifax Check Servs.*, 181 F.3d 832, 834 (7th Cir. 1999); *Chamberlan v. Ford Motor Co.*, 402 F.3d 952 (9th Cir. 2005); *Unger v. Amedisys*, Inc., 401 F.3d 316 (5th Cir. 2005); *Wal-Mart Stores, Inc. v. Visa U.S.A., Inc.*, 280 F.3d 124, 148 (2d Cir. 2001).

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.[291] 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.

Two Supreme Court cases in particular have created inter- and intra-circuit conflicts. In *Eisen v. Carlisle & Jacquelin*,[292] 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 Tel. Co. of the Southwest v. Falcon*,[293] 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 is the sole outlier, binding district courts to its unique and creative evidentiary standard.

---

[291] See FED. R. CIV. P. 23(f).
[292] 417 U.S. 156, 177 (1974).
[293] 457 U.S. 147, 160-161 (1982).

a. *The Second Circuit: In re IPO*

The appeal in *In re Initial Public Offerings Securities Litigation*,[294] 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 a district judge has some leeway as to [Rule 23] requirements."[295] But that leeway is not limitless: "[t]o 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." 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 this requirement was met or not met." 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."[296]

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

---

[294] 471 F.3d 24 (2d Cir. 2006).
[295] *Id*. at 40.
[296] *Id*. at 41.

[certification] requirement simply by being not fatally flawed."[297] 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).[298] 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] requirement has been met, just as the judge would resolve a dispute about any other threshold prerequisite for continuing a lawsuit."[299]

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 judge's merits inquiry had nothing to do with determining the requirements for class certification."[300] 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

---

[297] *Id*. at 42. 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 Litig.*, 280 F.3d 124 (2d. Cir. 2001); *Caridad v. Metro-North Commuter R.R.*, 191 F.3d 283 (2d. Cir. 1999).

[298] *In re IPO*, 471 F.3d at 33 n.3.

[299] *Id*. at 42. 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."

[300] 471 F.3d at 33.

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.[301] 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.*, discussed *infra* Section V.B.1.c.[302]

b. 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.*,[303] – 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* Section IV.A.

---

[301] *In re Initial Public Offerings Secs. Litig.*, 483 F.3d 70 (2d Cir. 2007).
[302] 474 F.3d 1214 (9th Cir. 2007).
[303] 482 F.3d 372 (5th Cir. 2007).

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):

> 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.[304]

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.

A petition for certiorari has been filed with the Supreme Court in the *Regents* case.[305] The Supreme Court could grant certiorari in the *Regents* case and hear it along with *In re Charter Commc'ns, Inc.*, an Eighth Circuit case dealing with the validity of scheme liability and in which the Supreme Court recently granted cert.[306] In hearing the

---

[304] *Regents*, 482 F.3d at 393.

[305] *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).

[306] 443 F.3d 987 (8th Cir. 2006), *cert. granted sub nom. Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007). *See supra* p. Section VI.A.1, for a discussion of *In re Charter Communications* and scheme liability generally.

Regents case, The Supreme Court could 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 *Oscar*.[307] 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. In holding that the fraud-on-the-market presumption of reliance was not appropriate in this case, the 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."[308] 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."[309] The Fifth Circuit thereby set forth a preponderance of admissible evidence standard to guide trial court inquiries.[310]

---

[307] *Oscar*, 2007 WL 1430225 at *5.

[308] *Id*. at *14.

[309] *Id*. at *6. 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*, 2007 WL 1430225 at *5 n.40. 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.

[310] 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*, 2007 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]

c. The Ninth Circuit: Dukes

Although not a securities case, the Ninth Circuit's decision in *Dukes v. Wal-Mart Stores, Inc.*,[311] 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 plaintiffs – all of whom were current and former female employees of Wal-Mart – class certification. Wal-Mart appealed. The Ninth Circuit upheld the lower court's decision, establishing a lenient standard for district court review of plaintiffs' certification evidence.

The Court first noted that the "party seeking certification bears the burden of showing" that it has met all the requirements of Rule 23.[312] 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

---

[Footnote continued from previous page]
inquiry." *Oscar*, 2007 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*.

[311] 474 F.3d 1214 (9th Cir. 2007).

[312] *Id.*, 474 F.3d at 1224.

certification stage. Rather, 'a lower *Daubert* standard should be employed at this stage of the proceedings.'"[313] The court 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."[314] 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."[315] Thus, while other circuits espouse "rigorous analysis" or the "preponderance of the evidence" standard, the Ninth Circuit clearly holds district courts to a less demanding "sufficiency of evidence" standard.

This view conflicts with other court of appeals' approaches to class certification. 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.

The panel's restrictive standard of inquiry also appears to conflict with prior Ninth Circuit decisions in the

---

[313] *Id*. at 1227 (quoting *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.
[314] *Dukes*, 474 F.3d at 1227.
[315] *Id.* at 1229 (quoting *In re Visa Check*, 280 F.3d 124, 135 (2d Cir. 2001); *see also Caridad*, 191 F.3d 283, 292-293 (2d Cir. 1999) (noting that a district court may not weigh conflicting expert evidence or engage in "statistical dueling" of experts).

securities arena. In its opinion in *Blackie v. Barrack*,[316] 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.*,[317] 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."[318] 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.[319] 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 Inquiries

The fraud-on-the-market doctrine is sometimes 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."[320] The fraud-on-the-market doctrine may permit "a trial court to presume that each class member has

---

[316] 524 F.2d 891, 897 (9th Cir. 1975).

[317] 976 F.2d 497, 509 (9th Cir. 1992).

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

[319] *See Id.*

[320] *Hevesi v. Citigroup Inc.*, 366 F.3d 70, 77 (2d. Cir. 2004).

satisfied the reliance element[321] of their 10b-5 claim. Without this presumption, questions of individual reliance would predominate, and the proposed class would fail."[322] The doctrine as articulated in *Basic* allows for each circuit to develop its own fraud-on-the-market rules.[323] The Second and Fifth Circuits recently have applied their newly announced Rule 23 standards to invocations of the *Basic* presumption.

The key underpinning of the fraud-on-the-market presumption is the efficient market hypothesis—the hypothesis that, in an open and developed securities market, the price of a security is determined by all the available information about the issuer of the security, and that such information is incorporated rapidly into the price by the impersonal intermediation of market traders.[324] At the time *Basic* and the earlier cases adopting the fraud-on-the-market theory were decided, the efficient market hypothesis on which the theory was based was widely accepted among economists, at least for stocks sold on national markets.[325]

---

[321] Except in limited circumstances, reliance is not an element of a violation of sections 11 or 12 of the Securities Act. 15 U.S.C. § 77k; 15 U.S.C. § 77l(1)-(2). Since liability under section 15 is derivative of the underlying violation of section 11 or 12, reliance is ordinarily not an element of a section 15 claim either. 15 U.S.C. § 77o. Thus, unlike actions brought under the anti-fraud provisions of the 1934 Securities Exchange Act, determining whether individual class members relied upon the alleged misstatements or omissions, except in limited circumstances, will not overwhelm the common issues presented and defeat the predominance requirement of Rule 23(b)(3).

[322] *Unger v. Amedisys*, 401 F.3d 316, 321 (5th Cir. 2005); *Gariety v. Grant Thornton, LLP*, 368 F.3d 356 (4th Cir. 2004); *Oscar*, 2007 WL 1430225 at *5-6.

[323] *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

[324] *Id.* at 241-42.

[325] *See, e.g.*, Fischer Black et al., *The Capital-Asset Pricing Model: Some Empirical Tests*, Studies in the Theory of Capital Markets 79 (Michael C.

[Footnote continued on next page]

Since that time, courts have routinely invoked the fraud-on-the-market theory and certified securities class actions in cases asserting violations of the antifraud provisions of the Exchange Act, where securities are publicly traded on a major exchange.

a. *Recent cases discussing market efficiency in the class certification context.*

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."[326] 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.

In the Fifth Circuit, plaintiffs are required to establish loss causation in order to take advantage of the reliance presumption.[327] That is, plaintiffs must prove that the

---

[Footnote continued from previous page]
Jensen ed. 1972); Eugene F. Fama & James D. MacBeth, *Risk, Return, and Equilibrium: Empirical Tests*, 81 J. Pol. Econ. 607 (1973); Eugene F. Fama et al., *The Adjustment of Stock prices to New Information*, 10 Int'l Econ. Rev. 95 (1978).

[326] *In re IPO*, 471 F.3d at 42-43.

[327] Loss causation is a prerequisite to the fraud-on-the-market presumption. As articulated in *Greenburg*: Reliance is presumed if the

[Footnote continued on next page]

defendant's non-disclosure materially affected the market price of the security.[328] 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? 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.[329] 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. *See supra* Section V.B.1.6. 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 the certification decision, and failing to insist upon a greater showing of loss causation to sustain certification."[330] But the majority found firm support for its conclusions in the amended text of Rule 23(c)(1)(A),

---

[Footnote continued from previous page]
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 Sys., Inc.*, 364 F.3d 657, 661 (5th Cir. 2004).

[328] *Oscar*, 2007 WL 1430225, at *7.

[329] 482 F.3d at 380-81, 386-88.

[330] *Oscar*, 2007 WL 1430225 at *4, *12.

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.*,[331] 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."[332]

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."[333] 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.

b. Courts have struggled with the question of how long it takes for information to be impounded into the stock price in an efficient market.

Where plaintiffs rely on the fraud-on-the-market theory of reliance they must allege and ultimately

---

[331] 401 F.3d 316 (5th Cir. 2005).
[332] *Oscar*, 2007 WL 1430225 at *5, *13-14 (quoting *Unger*, 401 F.3d at 321, 325).
[333] *See supra* Section V.B.1.6.

demonstrate that the market in which the affected stock traded was "efficient."[334] That theory[335] is based on the premise that investors rely on the market price of securities as an accurate measure of their intrinsic value.[336] In the *Basic* context, courts are referring to "informational efficiency," not "fundamental value efficiency."[337] Informational efficiency requires that publicly available information be absorbed by the stock price; fundamental value efficiency would require that the stock price respond to that information accurately, as well.[338]

The Supreme Court in *Basic* stated: "we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in the market price."[339] In general, courts have held that where a market for a particular stock is efficient, new information disclosed to the marketplace becomes reflected in the stock's

---

[334] *Basic Inc. v. Levinson*, 485 U.S. 224, 248 n.27 (1988).

[335] There are three levels of the efficient market hypothesis, weak, semi-strong, and strong. *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.*, 2006 U.S. Dist. LEXIS 52991, at *29 (S.D.N.Y. 2006). The prevailing definition of market efficiency, semi-strong, mandates that the market price reflect all publicly available information. *Id*. (citing *In re Polymedica*, 432 F.3d at 10); *see also West v. Prudential Secs., Inc.*, 282 F.3d 935, 938 (7th Cir. 2002).

[336] *Basic*, 485 U.S. at 246-47; *see also In Re: Initial Public Offering Secs. Litig.*, 471 F.3d 24, 56 (2d Cir. 2006). There are three levels of the efficient market hypothesis, weak, semi-strong, and strong. *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.*, 2006 U.S. Dist. LEXIS 52991, at *29 (S.D.N.Y. Aug. 1, 2006). The prevailing definition of market efficiency, semi-strong, mandates that the market price reflect all publicly available information. *Id*. (citing *In re Polymedica*, 432 F.3d at 10); *see also West*, 282 F.3d at 938.

[337] *Polymedica*, 432 F.3d at 14-15; *see also Oscar*, 2007 WL 1430225 at *7.

[338] *Polymedica*, 432 F.3d at 19.

[339] *Basic*, 485 U.S. at 249 n.28.

price "rapidly" or "almost immediately."[340] Although its precedent is somewhat self-contradictory, the Ninth Circuit, in at least one case, has rejected any "bright-line rule requiring an immediate market reaction" because of the potential for "distortions that prevent the ideal of 'a free and open public market' from occurring."[341]

Beyond requiring that the "market price responds so quickly to new information that ordinary investors cannot

---

[340] *Unger v. Amedisys, Inc.*, 401 F.3d 316, 324 (5th Cir. 2005); *In re Xcelera.com Sec. Litig.*, 430 F.3d 503, 508 (1st Cir. 2005); *Cammer v. Bloom*, 711 F. Supp. 1264, 1276 n.17 (D.N.J. 1989) ("An efficient market is one which rapidly reflects new information in price."); *In Re: Merck & Co., Inc. Sec. Litig.*, 432 F.3d 261, 269 n.5 (3d Cir. 2005) (citing *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997); *see also Basic*, 485 U.S. at 246 (noting the premise that "the market price of shares traded on well-developed markets reflects all publicly available information"); *Barrie v. Intervoice Brite, Inc.*, 2006 U.S. Dist. LEXIS 69299, at *25 (N.D. Tex. 2006) ("Evidence of a causal relationship between unexpected corporate events or financial releases and an immediate response in the price of the stock is an important indicator of market efficiency."); *In re: Merck & Co., Inc. Sec. Litig.*, 432 F.3d at 269 (stating that if a market is efficient, "information is absorbed into a firm's stock price" "in the period immediately following the disclosure," but that "[t]his does not mean instantaneously").

[341] *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 947 (9th Cir. 2003) (citing *Basic*, 485 U.S. at 246); *but see Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1052 (9th Cir. 2006) (holding information "was disseminated into an efficient market and was reflected in the market price"); *Binder v. Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999); *In re NextCard, Inc. Secs. Litig.*, 2006 U.S. Dist. LEXIS 16156, at *8-9 (N.D. Cal. Mar. 20, 2006) ("Because publicly available information is reflected in the market price, an investor's reliance on the price necessarily means that the investor is relying upon any public material misrepresentations or omissions."); *In re Remec Inc. Sec. Litig.*, 415 F. Supp. 2d 1106, 1113 (S.D. Cal. 2006) ("under an efficient market view, the market had assimilated the information").

make trading profits on the basis of such information,"[342] few lower courts have opined as to what "rapidly" or "immediately" means. On of the few courts to do so is the District of Massachusetts in the *Polymedica* case.[343] On remand from the First Circuit's decision vacating the district court's class certification order, the district court stated that:

> 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 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*.[344] (emphasis added)

The court qualified that by saying that the reaction should be completed on "the next trading day, if the news is released after the market has closed."[345] Similarly, in *Krogman v. Sterritt*,[346] in response to an expert's argument that "the impact of news on the price of a stock…will typically last approximately one week to ten days," the court concluded that "such a lengthy time frame is inconsistent with the concept of market efficiency."

Other courts have indicated that an efficient market might require two days to absorb information. At least one

---

[342] *In re Polymedica Corp. Secs. Litig.*, 432 F.3d 1, 8-9, 19 (1st Cir. 2005); *see also Teamsters Local 445 Freight Div. Pension Fund*, 2006 U.S. Dist. LEXIS 52991, at *27.

[343] *In re Polymedica Corp. Secs. Litig.*, 453 F. Supp. 2d 260, 278 (D. Mass. 2006).

[344] 453 F. Supp. 2d at 278.

[345] *Id*. at 278 n.22.

[346] 202 F.R.D. 467, 477 n.14 (N.D. Tex. 2001).

court, *Lehocky v. Tidel Techs., Inc.*, appears to have determined that a curative disclosure causes a loss that occurred within "two-day periods" of disclosure to the market.[347] Similarly, in *In re Xcelera.com Securities Litigation*, the First Circuit recognized defendants' objection to an event study which purported to demonstrate statistically significant drops in a company's stock price over multi-day windows.[348] The court did not specifically address longer periods, but implied that two-day windows might be appropriate.[349] These cases are less fully reasoned than the *Polymedica* decision.

There are only a few cases that contain language that might be construed as implying a longer period in which a market might absorb public information. In connection with a discussion of the "lookback provision" set out at 15 U.S.C. § 78u-4(e), the court in *In re Oxford Health Plans, Inc. Sec. Litig.*, stated:

> The damages of a purchaser were always understood to be the difference between the purchase price and the true value of the shares (adjusted for any negative causation) as disclosed after the revelation of the fraud to the public, followed by *a reasonable period (usually no longer than a week or ten days)* during which the market took cognizance of the fraud and the publicly traded price was presumed, under the "efficient market"

---

[347] 220 F.R.D. 491, 506-07 & n.19 (S.D. Tex. 2004).

[348] 430 F.3d 503, 513 n.11 (1st Cir. 2005).

[349] *Id.* (citing Macey, *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson*, 77 Va. L. Rev. 1017, 1031 (1991); *Lehocky v. Tidel Techs., Inc.*, 220 F.R.D. 491, 506-07 (S.D. Tex. 2004)); *see also In re 2themart.com, Inc. Sec. Litig.*, 114 F. Supp. 2d 955, 964-65 (C.D. Cal. 2000) (considering price increase over two days of trading).

> hypothesis endorsed by the Supreme Court in *Basic*, to reflect an adjustment for the fraud.[350] (emphasis added)

Later in the opinion, the *Oxford Health* court does imply that overcorrection is the main reason to elongate the period of time in which a market can be said to have absorbed information:

> Common sense suggests that the sudden revelation of a fraud may cause a momentary overcorrection of the market price, and a dearth of potential buyers may exist for a longer period while whatever cloud the revelation placed on the issuer, dissipates.[351]

Although the *Oxford Health* court invoked the "'efficient market' hypothesis endorsed by the Supreme Court in *Basic*," it can be argued that the look back provision is aimed toward determining *fundamental value efficiency*. The district court decision in *In re Polymedica*, *supra*, would suggest that this language is inapplicable to a discussion of the amount of time required for a market to be

---

[350] 244 F. Supp. 2d 247, 250 (S.D.N.Y. 2003) (emphasis added); *see also In re: Royal Dutch/Shell Trans. Secs. Litig.*, 404 F. Supp. 2d 605, 610 & n.4 (D.N.J. 2005).

[351] 244 F. Supp. 2d at 250-51; *see also SEC v. Butler*, 2005 U.S. Dist. LEXIS 7194, at *37-38 (W.D. Pa. April 18, 2005) ("the recovery of a substantial part of the decrease during the first day following [the company's] announcement and the regaining of the entire initial loss within three (3) days, negates any inference of materiality, because it indicates that investors quickly determined that the 'new' information was not material to their investment decisions") (citing *In re Allied Capital Corp. Sec. Litig.*, 2003 U.S. Dist. LEXIS 6962, at *18-19 (S.D.N.Y. Apr. 25, 2003)); *Westinghouse Elec. Corp. v. '21' Int'l Holdings, Inc.*, 821 F. Supp. 212, 219-20 (S.D.N.Y. 1993) (no change in the market's valuation where the stock recovered within five trading days of the announcement of new information).

informationally efficient.[352] As the court notes, the lookback period is aimed toward "determining the time period during which the efficient market adjusts from the inflated value to the *true value*."[353]

VI. RECENT DECISIONS ON LOSS CAUSATION

Since the landmark decision two years ago in *Dura Pharmaceuticals, Inc. v. Broudo*,[354] the federal courts have had numerous opportunities to apply the Supreme Court's ruling on how loss causation[355] must be pled and proven in class actions under the Private Securities Litigation Reform Act.[356] While the Supreme Court generally 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, it has also become apparent that *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 the stock

---

[352] 432 F.3d at 10.

[353] 244 F. Supp. 2d at 250-51 (emphasis added).

[354] 544 U.S. 336 (2005).

[355] The Private Securities Litigation Reform Act (PSLRA) provides that, "In any private action arising under this [chapter], the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4).

[356] Under Section 11 of the Securities Act, 15. U.S.C. § 87k(e), defendants bear the burden of proving lack of loss causation as a defense. *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407 (9th Cir. 1994); *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248 (N.D. Cal. 2000); *McMahan & Co. v. Wherehouse Entm't, Inc.*, 65 F.3d 1044 (2d Cir. 1995).

price does not immediately react to a particular curative disclosure.

A. The Teachings of *Dura*

1. The Supreme Court's Decision.

In *Dura,*[357] certiorari was granted to resolve the circuit split on pleading standards for loss causation, and the obvious basic flaws with the Ninth Circuit's approach, which had rendered price inflation at the time of purchase of a security, alone, sufficient to prove loss causation.[358] Other circuits had held that pleading and proving that a plaintiff purchased securities at an artificially inflated price without proof of the impact of the fraud on the price by a decline in value following disclosure of the fraud was insufficient to satisfy the PSLRA.[359] The Supreme Court approved the majority view.

Dura was, of course, a pleading case, but its holdings also apply to the issue of *proving* loss causation. *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

---

[357] The *Dura* decision is one of the rare Supreme Court decisions on the securities laws in the last several decades. However, the Roberts Court appears to be showing more interest in securities cases. In March 2007, the Court heard oral argument in *Makor Issues & Rights, Ltd. v. Tellabs, Inc.* (Docket No. 06-484), on the issue of PSLRA pleading standards and also granted certiorari in *Stoneridge Investment v. Scientific Atlanta* (Docket No. 06-43), on the issue of what constitutes "deceptive conduct" under Section 10(b).

[358] *Broudo v. Dura Pharms., Inc.*, 339 F.3d 1059 (9th Cir. 1999).

[359] *See, e.g., Bastian v. Petron Res. Corp.*, 892 F.2d 680 (7th Cir. 1990); *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (3d Cir. 2003); *Semerenko v. Cendant Corp.*, 223 F.3d 165 (2d Cir. 2000); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997).

causation. *Second*, the Court held that *fraud* must cause the loss, *i.e.*, proximately cause a subsequent decline in stock price. The Court stated this rule for loss causation:

> a person who "misrepresents the financial condition of a corporation in order to sell its stock" becomes liable to a relying purchaser "for the loss" the purchaser sustains "when the facts…become generally known" and "as a result" share value depreciate[s].[360]

Third, 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 causation, 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 discussed 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.

---

[360] 544 U.S. at 344 (citing Restatement of Torts § 548A, cmt. b at 107).

2. *Dura* on Remand.

Following the Supreme Court decision remanding the case, the Northern District of California ("*Dura II*") denied, in part, the defendants' motion to dismiss.[361] 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 percent stock price drop, did *not* address problems with the asthma drug, and that disclosure was found insufficient to plead loss causation.

But plaintiffs persevered. 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 so defining the class period. The district court also rejected 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 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.[362]

---

[361] 2006 U.S. Dist. LEXIS 41193 (S.D. Cal. 2006).

[362] After the district court issued this ruling, plaintiffs further amended their 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.

B. Key Issues Being Litigated after *Dura*

Since the Supreme Court decision, there have been literally hundreds of reported cases citing *Dura*, but only a relative handful decided at the appellate level. Following is a discussion of recent decisions in key areas.

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

One of the tasks facing federal courts after *Dura* is the question of whether allegations of loss causation must meet the heightened pleading standards of Rule 9(b) or the PSLRA, or whether a "short plain statement" under Rule 8(a)(2) is enough. While the *Dura* court evaluated the claim under Rule 8(a)(2), it did not explicitly decide the issue, noting that it assumed without deciding "that neither the Rules nor the securities statutes impose any special further requirement in respect to the pleading of proximate causation or economic loss."[363]

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*.[364] However, loss

---

[363] 544 U.S. at 346.

[364] *See In re Tyco Int'l, Ltd.*, MDL No. 02-1335-PB, Case No. 03-cv-1352-PB (D.N.H. June 12, 2007) (citing *In re Tyco Int'l, Ltd.*, 236 F.R.D. 62, 71 (D.N.H. 2006)); *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"); *see also In re Daou Systems, Inc. Sec. Litig.*, 411 F.3d 1006 (9th Cir. 2005); *Ong v. Sears Roebuck & Co.*, 459 F. Supp. 2d 729 (N.D. Ill. 2006); *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).

causation may be viewed as one of the "circumstances constituting fraud," and a number of courts have required that loss causation be pled under the heightened standard of under Rule 9(b).[365]

2. Content of the Curative Disclosure

Several cases have attempted to delineate what a disclosure must contain to be curative of a previous material misstatement or omission, such that a subsequent stock price drop would be deemed to have caused the loss.

In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,[366] the Fifth Circuit addressed the standard for establishing loss causation at the class certification stage of litigation.[367] 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 quarterly reports contained positive growth in revenues and earnings, but allegedly misstated the number of telephone lines it had installed. Allegiance's fourth quarter announcement in February contained corrections of numerous items from previous reports, including the line count. Already on a downward move, Allegiance's stock continued to drop the trading day following the fourth quarter announcement, and

---

[365] *See, e.g., In re First Union Corp Sec Litig*., 2006 U.S. Dist. LEXIS 5083 (W.D.N.C. Jan. 20, 2006) (collecting cases).

[366] 2007 WL 1430225 (5th Cir. May 16, 2007).

[367] This holding also 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* loss 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.

the company filed for bankruptcy within 90 days. Plaintiffs sued, alleging that officers made misrepresentations regarding these line counts in the earlier quarterly results, and the district court certified a class.

On appeal, the Fifth Circuit held that plaintiffs had to prove that the disclosure of the previous material misstatement or omission regarding line counts caused the loss, but that plaintiffs had not demonstrated that they could separate other negative news released at the same time. Therefore, plaintiffs could not prove that the curative release had caused their loss.

In Brumbaugh v. Wave Sys. Corp., the court, in ruling on defendants' motion to dismiss, found plaintiffs' allegations sufficient to plead loss causation.[368] 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. The plaintiffs also alleged that news of an SEC investigation relating to these misleading statements sent shares down 17.13% the following day. Defendants argued that disclosure of the SEC investigation was not an admission that the earlier statements were themselves misleading. The court cited *Dura* for the proposition that a corrective disclosure need not precede a stock's decline. The court found that the complaint contained "the very allegations regarding share price decrease and public exposure to the

---

[368] 416 F. Supp. 2d 239, 256 (D. Mass. 2006).

truth the Supreme Court found lacking in the *Dura* complaint."[369]

Similarly, the district court in *Lapin v. Goldman Sachs Group*,[370] a case involving charges of tainted analyst research reports issued by Goldman Sachs, 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."

In *Leykin v. AT&T Corp.*,[371] the district court below had found that investor plaintiffs failed to allege loss causation in a technology misappropriation scheme allegedly perpetrated by controlling stockholder.[372] The district court

[369] *Id.* at 256 (citing *In re Immune Response Secs. Litig.*, 375 F. Supp. 2d 983, 1025 (S.D. Cal. 2005)).
[370] 2006 U.S. Dist LEXIS 71417 (S.D.N.Y. Sept. 29, 2006).
[371] 2007 U.S. App. LEXIS 2378 (2d Cir. Jan. 30, 2007).
[372] *Leykin v. AT&T Corp.*, 423 F. Supp. 2d 229, 234 (S.D.N.Y. 2006).

found that plaintiffs had made no showing that the stock price decline resulted from the disclosure of any error in previous financial statements or alleged misconduct as opposed to a market-wide Internet stock collapse. In an 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.[373]

In *In re Tower Automotive Securities Litigation*,[374] 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. The Southern District of New York found that plaintiffs' complaint 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. 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.

---

[373] *Leykin,* 2007 U.S. App. LEXIS 2378 at *4; *Leykin,* 423 F. Supp. at 246.
[374] 2007 U.S. Dist. LEXIS 29491, at *56 (S.D.N.Y. Apr. 14, 2007).

In *Harrison v. Rubenstein*,[375] 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. 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. However, the court held that since the disclosures regarding mismanagement were not ones that Cornerstone was legally obliged to make, plaintiffs' allegations of the underlying instances of mismanagement did not establish loss causation. 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. The steady decline in stock prices may therefore have had many causes, but plaintiffs failed to allege that fraud was one of those causes. The court also denied plaintiffs' motion to amend the complaint a second time, determining that allowing the plaintiffs a "third bite at the apple" would not change the fact that their suit was fundamentally without merit.

In *Glaser v. Enzo Biochem*,[376] the Fourth Circuit 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

---

[375] 2007 U.S. Dist. LEXIS 13118 (S.D.N.Y. Feb. 22, 2007).
[376] 464 F.3d 474 (4th Cir. 2006).

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.

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.

Another Fourth Circuit decision sets an even more aggressive standard for pleading loss causation than the *Glaser* case. In *Teachers' Retirement System of Louisiana v. Hunter*,[377] 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

[377] 477 F.3d 162 (4th Cir. 2007).

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 the corporations operations." 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."

In *D.E. & J. Ltd. P'shp v. Conaway*,[378] the Sixth Circuit (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 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

[378] 133 Fed. Appx. 994 (6th Cir. 2005), affirming *D.E. & J L.P. v. Conaway*, 284 F. Supp. 2d 719 (E.D. Mich. 2003).

of a bankruptcy petition by itself does not a security 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 a price drop 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.

In a summary judgment case, *In re Motorola Sec. Litig.*,[379] 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. Motorola argued that plaintiff could not *prove* loss causation under *Dura*, because the series of announcements that 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 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.[380] 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.[381] The district

[379] 2007 U.S. Dist. LEXIS 9530 (N.D. Ill. Feb. 8, 2007).
[380] *Id.* at *96-103 (quoting *Dura*, 544 U.S. at 343).
[381] *Id.* at *127. 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

[Footnote continued on next page]

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."[382]

In *Knollenberg v. Harmonic, Inc.*,[383] 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

---

[Footnote continued from previous page]
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.

[382] *See id.* at *129 (quoting *Dura Pharms*., 544 U.S. at 342); compare *Tricontinental Indus. v. PricewaterhouseCoopers LLP*, 475 F.3d 824 (7th Cir. 2007), discussed *infra* at Section VI.D.

[383] 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)).

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.

In *In re Daou Systems, Inc. Sec. Litig.*,[384] the Ninth Circuit 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. The Ninth Circuit also held that stock price declines that preceded the first revelations of adverse facts in August 1998 were irrelevant, 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."

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

Following *Dura*, district courts have struggled with the issue of whether all the "curative" facts must be disclosed at the time of a stock price decline.[385]

---

[384] 411 F.3d 1006 (9th Cir. 2005); *see also In re Impax Labs., Inc. Sec. Litig.*, 2007 U.S. Dist. LEXIS 723 (N.D. Cal. Jan. 3, 2007).

[385] At least one recent case has declined to deal with the issue at the class certification stage, holding that because loss causation need not be pleaded with particularity, plaintiffs might later identify curative disclosures not identified in the complaint. *See In re Tyco Int'l, Ltd.*,

[Footnote continued on next page]

As discussed above, several courts have *not* required disclosure of "fraud" per se, but only facts sufficient to reveal the general adverse conditions or circumstances.[386] 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. 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.

In *In re Gilead Sciences Securities Litigation*,[387] the Northern District of California granted defendants' motion to dismiss for failure to meet the requirements of pleading loss causation under *Dura*. 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

---

[Footnote continued from previous page]
MDL No. 02-1335-PB, Case No. 03-cv-1352-PB (D.N.H. June 12, 2007) (citing *In re Tyco Int'l, Ltd.*, 236 F.R.D. 62, 71 (D.N.H. 2006)).

[386] *See, e.g., In re Daou Sys.*, 411 F.3d 1006 (9th Cir. 2005) (company's disclosure of increased unbilled receivables tied directly to plaintiffs' allegations of financial fraud in the form of premature recognition of revenue); *Lapin v. Goldman Sachs Group,* 2006 U.S. Dist. LEXIS 71417 (S.D.N.Y 2006).

[387] 2006 WL 1320466 (N.D. Cal. May 12, 2006).

promotion (*i.e.*, marketing of the drug inconsistent with the contents of FDA-approved package labels) began in September 2001 and was responsible for over 85% of Viread sales, which grew to 20% of the antiretroviral drug market share. 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. 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. 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. Plaintiffs also alleged that decreases in sales and share values were a foreseeable result of Gilead's marketing techniques.

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. 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.[388] 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

---

[388] *See also In Re: Merck & Co., Inc. Sec. Litig.*, 432 F.3d 261, 269-70 (3d Cir. 2005) (disclosure not material where stock price did not fall for a month); *In re NAHC, Inc. Sec. Litig.*, 306 F.3d 1314, 1331 (3d Cir. 2002) ("If the disclosure of certain information has no effect on stock prices, it follows that the information disclosed was immaterial as a matter of law."); *but see Steiner v. Medquist, Inc.*, 2006 U.S. Dist. LEXIS 71952, at *39-40 (D.N.J. 2006) (underlying fraud revealed through series of partial disclosures).

unsuccessful. 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. 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.

With similar logic, the Northern District of California dismissed a complaint for failure to allege causation, when the stock price already had dropped significantly prior to a corrective disclosure. In *In re Redback Networks,* [389] plaintiffs alleged that Redback's officers and directors 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. 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. The court found, however, that the resulting revenue was real and was earned by Redback in return for the sale of its products. 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. 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

---

[389] *In re Redback Networks, Inc. Sec. Litig.*, 2007 U.S. Dist. LEXIS 27389 (N.D. Cal. Mar. 30, 2007).

share prior to June 2001. By the time the actual concealed facts about the fraudulent practices relating to sales became public, the share price already had dropped to below $1 per share. Thus, the court concluded, only a negligible portion of the stock price drop was caused by the alleged fraudulent practices relating to sales. 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.

In a recent, and remarkably succinct, opinion, the Southern District of New York dismissed a complaint that did not indicate when the stock was bought or sold:

> Plaintiff alleges that he purchased or otherwise acquired his shares at some unspecified time during the Class Period. He does not say at what price or prices. Nor does he say that he ever sold it or, for that matter, that he suffered any loss. Rather, the complaint contents itself with the allegations that he bought at an artificially inflated price, that the market price of [defendant's] shares "plunged to a 30 month low…on October 26, 2005, and that he suffered "damages" when the previously concealed information came out.[390]

The court remarked that these were exactly the type of allegations that *Dura* held to be insufficient, noting that it was possible, given the movement of the stock price, that the plaintiff actually profited from his transaction in the defendant's stock.

[390] *In re: Estee Lauder Companies Secs. Litig.*, 06-2505-LAK (S.D.N.Y. May 21, 2007).

D. Claims Against "Secondary Actors"

Various recent cases have 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 post-*Dura* issue of 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 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 seem 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.[391]

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

---

[391] *See, e.g.*, *Newby v. Enron Corp.*, 2006 U.S. Dist. LEXIS 43146 (S.D. Tex. 2006).

period.[392] 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." 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)."[393] 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 to 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.*

---

392 *Regents of the University of California v. Credit Suisse First Boston (USA) Inc.*, 482 F.3d 372 (5th Cir. 2007).
393 *Id*. at 407.

Securities, Deriv. & ERISA Litig.,[394] 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, and created a false impression of a financially strong Enron. Thus, she said, "[t]he 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*.,[395] the court held that investors could amend their complaint to add new claims against two secondary actors, Microsoft and Softbank, as counterparties

---

[394] 439 F. Supp. 2d 692 (S.D. Tex. 2006).
[395] 2006 U.S. Dist. LEXIS 39030 (S.D.N.Y. June 13, 2006).

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.

Auditor Liability Cases. In *Lattanzio v. Deloitte & Touche LLP*,[396] 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." 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,

---

[396] 476 F.3d 147 (2d Cir. 2007).

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."

In *Tricontinental Indus., Ltd. v. PricewaterhouseCoopers*,[397] 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.

Analyst Research Report Cases. In *In re Credit Suisse-AOL Sec. Litig.*,[398] 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

---

[397] 475 F.3d 824 (7th Cir. 2007).
[398] 465 F. Supp. 2d 34 (D. Mass. 2006).

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."[399] The court also rejected the argument that investors already were aware of the known risks to AOL.

In *Quaak v. Dexia, S.A.,*[400] 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 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. 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'

---

[399] The court distinguished the Second Circuit decision in *Lentell v. Merrill Lynch,* 396 F.3d 161 (2d Cir. 2005).
[400] 445 F. Supp. 2d 130 (D. Mass. 2006).

damages. 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.

In *Joffee v. Lehman Bros, Inc.*,[401] the Second Circuit affirmed dismissal of a PSLRA case on loss causation grounds. 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.

Fund Manager/Broker Liability Cases. The Seventh Circuit recently affirmed a summary judgment decision dismissing plaintiffs' claim in *Ray v. Citigroup Global Markets*.[402] 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.

[401] 2006 U.S. App. LEXIS 31487 (2d Cir. Dec. 19, 2006) (unpublished).
[402] 482 F.3d 991 (7th Cir. 2007).

Citing *Caremark, Inc. v. Coram Healthcare Corp*.,[403] the Seventh Circuit 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 circumstances that the fraud concealed, the investment…would not have lost its value."[404] 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. 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.

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*. 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.

In *In re Salomon Smith Barney Mutual Fund Fees Litig.*,[405] the Southern District of New York dismissed plaintiffs' securities claims for failure adequately to allege loss causation. Class action plaintiffs included investors who

---

[403] 113 F.3d 645 (7th Cir. 1997).
[404] 482 F.3d at 995 (citing *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir. 1990)).
[405] 441 F. Supp. 2d 579 (S.D.N.Y. 2006).

purchased or held funds organized and offered by SSB between March 22, 1999, and March 22, 2004. 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, because 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. 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."[406]

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. 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. 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.

---

[406] 441 F. Supp. 2d at 589 (citing *In re Morgan Stanley*, 2006 U.S. Dist. LEXIS 20758, at *39 and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975)).

In re AIG Advisor Group Securities Litigation[407] involved claims that AIG brokers falsely stated that they were providing objective investment advice while actually engaging in an incentive-driven scheme to push the sale of particular stock. 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. The court found 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*. 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. 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.

E. The Role of Economic Modeling in Alleging Loss Causation

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

[407] 2007 U.S. Dist. LEXIS 30179 (E.D.N.Y. Apr. 25, 2007).

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*,[408] the Northern District of Illinois denied the defendants' motion to dismiss on 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 a 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 questionable, because 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."

---

[408] 429 F. Supp. 2d 960 (N.D. Ill. 2006).

In *City of Sterling Heights Police & Fire Retirement System v. Abbey Nat'l, Inc.*,[409] 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."

In *In re Impax Laboratories, Inc. Sec. Litig.*,[410] the Northern District of California 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.

---

[409] 423 F. Supp. 2d 348 (S.D.N.Y. March 31, 2006).
[410] 2007 U.S. Dist. LEXIS 723 (N.D. Cal. Jan. 3, 2007).

F. 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.*,[411] the court held that in-and-out traders may be able to prove loss causation, and certifying class including such class members.[412]

However, in *In re Cornerstone Propane Partners, L.P. Securities Litigation*,[413] a California district court ruled on a motion to certify a class pursuant to Rule 23. 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. Cornerstone's stock decline began following a press release on July 27, 2001. 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. 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.

---

[411] 232 F.R.D. 534 (E.D. Va. 2006).
[412] *Compare Glaser v. Enzo Biochem, supra* (holding that plaintiffs had sold their shares prior to the curative disclosure, and therefore could not establish loss causation under *Dura*); *In re Compuware Sec. Litig.*, 386 F. Supp. 2d 913, 920 (E.D. Mich. 2005) (granting summary judgment where named plaintiff traded out of defendants' stock before disclosure of the alleged fraud).
[413] 2006 U.S. Dist. LEXIS 25819 (N.D. Cal. May 3, 2006).

G. "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 & Co.,*[414] 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.[415]

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*,[416] the Court once again issued a SLUSA interpretation in *Kircher v. Putnam Funds Trust*.[417] 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

---

[414] 459 F. Supp. 2d 729 (N.D. Ill. 2006).
[415] *Compare Royal Dutch Shell*, 404 F. Supp. 2d 605 (D.N.J. 2005), and *Knollenberg*, *supra* at Section VI.B.
[416] 574 U.S. 71 (2006).
[417] 126 S. Ct. 2145 (2006).

substantially identical claims to those alleged in *Dabit*,[418] 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* [419], 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 . . . ."[420] 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 Section 1447(d) was not applicable.[421] 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."[422]

Litigation then proceeded in the Seventh Circuit on the substantive preemption claim, where the court held that

---

418 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.

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

420 28 U.S.C. § 1447(d).

421 *Kircher I*, 373 F.3d at 850.

422 *Id.*

plaintiffs' holder claims were precluded by SLUSA.[423] 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."[424]

While these proceedings continued in the Seventh Circuit, the Supreme Court granted certiorari on the predicate procedural question of appealability resolved in *Kircher I*.[425] 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.[426] 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."[427] 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.[428]

In the wake of *Kircher*, there can be no federal court review of a remand to state court, "whether or not that order

---

[423] *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005) (*Kircher II*).
[424] *Dabit*, 126 S. Ct. at 1507.
[425] *See Kircher v. Putnam Funds Trust*, 126 S. Ct. 2145 (2006) (*Kircher III*).
[426] *Id.*
[427] *Id.* at 2157.
[428] *id.* at 2156 - 57.

might be deemed erroneous."[429] 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.

B. Other Recent Decisions and Unresolved Issues Under SLUSA

The Supreme Court's holding in *Dabit* resolved a major question regarding the breadth of SLUSA's preclusion provisions, but the circuit courts and district courts continue to grapple with ancillary questions as plaintiffs adjust their claims in order to evade SLUSA's preclusive swath. Courts at varying levels have recently entered decisions related to each of SLUSA's four criteria for preclusion: (A) that the suit be a "covered class action," (B) that the claims be based upon state law, (C) that the claims be based on misrepresentations or omissions of material facts, and (D) that the omissions or misrepresentations be "in connection with the purchase or sale of a covered security." *See* 15 U.S.C. §§ 77p(b), 78bb(f)(1). There have also been a handful of new decisions interpreting the Delaware carve-out that exempts actions brought based upon the law of the state of incorporation.

C. Covered Class Actions

In *W.R. Huff Asset Mgmt. Co. v. Kohlberg, Kravis, Roberts, KKR Assocs. LP*,[430] the Eleventh Circuit held that a

---

[429] *Id.* at 2153.
[430] 209 Fed. Appx. 931 (11th Cir. 2006).

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.[431] 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.[432] 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."[433]

In *Peregrine Litigation Trust v. John J. Moores et al.*,[434] the addressed the question of what types of trusts deserve entity status when counting the number of plaintiffs.[435] 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

---

[431] 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).
[432] *Id.* at 933.
[433] *Id.* at 935.
[434] No. gic-788659 (San Diego Sup. Ct. Cal. May 2, 2007).
[435] 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).

created for “all purposes” and “not just for the purpose of pursuing causes of action.”[436]

1. 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,*[437] 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.

Most courts to have addressed the issue have determined that claims omitting allegations of misrepresentation or material omission are not preempted by SLUSA.[438]

---

[436] *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).

[437] 430 U.S. 462 (1977).

[438] *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

[Footnote continued on next page]

Other courts, however, have found that when securities plaintiffs attempt to "strip out" allegations of misrepresentation and fraud, and re-plead their claims 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*,[439]

2. "In Connection With"

In *Gavin v. AT&T Corp.*,[440] 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.[441] 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

---

[Footnote continued from previous page]
breach of contract claim avoided SLUSA preemption, but finding that the complaint failed to make out a contract violation).

[439] 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.")

[440] 464 F.3d 634 (7th Cir. 2006).

[441] *Id.* at 638.

complete "is a separate wrong . . . unless the wrong is a breach of warranty."[442]

3. "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*,[443] 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 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.[444] 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."[445]

---

[442] *Id.* at 639.
[443] 445 F. Supp. 2d 366 (S.D.N.Y. 2006).
[444] *Id.* at 372.
[445] *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").

In *Proctor v. Vishay Intertechnology, Inc.*,[446] 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.[447] 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."[448] The court agreed with the defendants and determined that plaintiffs' conception of the carve-out would be "far too broad."[449] The court therefore held that the "Delaware carve-out relates only to communications that are directly related to the exercise of shareholders' voting rights."[450]

VIII. PRE-TRIAL MOTIONS

A. Motions in Limine

A federal district court manages the admission of evidence before trial by ruling on motions *in limine*. Pre-trial motions *in limine* are used to prevent the introduction of harmful evidence, to resolve legal issues, and to streamline evidence at trial. Motions *in limine* may also be used proactively to ensure the admission of certain types of

---

[446] 2007 U.S. Dist. LEXIS 14547 (N.D. Cal. Feb. 13, 2007).
[447] *Id.* at *18.
[448] *Id.* at *20.
[449] *Id.* at *21.
[450] *Id.*

evidence, so that parties know they can rely on particular evidence when preparing for trial. This section discusses examples of motions *in limine* recently made in securities cases.

1. The Drawing of Adverse Inferences from Assertions of the Fifth Amendment Privilege Against Self-Incrimination

Motions *in limine* may determine the impact of a party's, or non-party's, assertion of the Fifth Amendment privilege against self-incrimination. Many defendants in securities fraud class actions may simultaneously be facing, or have previously faced, criminal investigations and/or prosecutions for the same conduct at issue in the civil suit. Thus, discovery from key witnesses may sometimes be unavailable because these witnesses will assert their respective Fifth Amendment privilege against self-incrimination and refuse to testify substantively until the criminal charges are resolved. In a civil proceeding, the plaintiff may move *in limine* to present evidence of the witness's invocation of the Fifth Amendment privilege and ask that the trier of fact draw an adverse inference from the invocation. An adverse inference can be drawn from a party's invocation of his or her Fifth Amendment privilege as long as there is "independent evidence" of the fact to be inferred.[451] When considering whether the inference is appropriate, the court will also consider the inference's

---

[451] *Doe ex rel. Rudy-Glanzer v. Glanzer*, 232 F.3d 1258, 1264 (9th Cir. 2000). *See also Baxter v. Palmigiano*, 425 U.S. 308, 318 (1976); *Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F. Supp. 2d 988, 1005 (W.D. Wash. 2004) (holding that a "Mea Culpa" document, spreadsheet and testimony were independent evidence of defendants' intent to deceive); *John Paul Mitchell Sys. v. Quality King Distrib.*, 106 F. Supp. 2d 462, 471 (S.D.N.Y. 2000).

relevance and potential for prejudice under Federal Rules of Evidence 401, 402, and 403.[452]

The District of Connecticut recently addressed these issues in an action brought by the Securities and Exchange Commission ("SEC"). In *Securities & Exchange Commission v. DiBella*, the court, in an unreported opinion, granted the government's motion *in limine*, which sought an adverse inference instruction based on defendant DiBella's invocation of the Fifth Amendment privilege.[453] In an earlier investigation by the SEC and United States Attorney, DiBella had initially invoked his Fifth Amendment privilege against self-incrimination and refused to answer questions. After the possibility of criminal charges was removed, DiBella waived his Fifth Amendment privilege and answered questions at a deposition.[454] However, DiBella then "could not recall details or events . . . due to the length of time that had passed."[455] The court found an adverse inference instruction appropriate because the probative value of DiBella's assertion of the privilege was not substantially outweighed by the danger of unfair prejudice. The court noted that "[a]llowing the jury to hear evidence of Defendant's invocation of the Fifth [A]mendment privilege prevents the privilege from being used as a weapon, which furthers the policy behind the inference."[456] The court allowed DiBella

---

[452] *Doe ex rel. Rudy-Glanzer*, 232 F.3d at 1266.

[453] *SEC v. DiBella*, No. 3:04 CV 1342 (EBB), 2007 WL 1395105, at *1 (D. Conn. May 8, 2007).

[454] *Id.* at *1-2.

[455] *Id.* at *4.

[456] *Id.* The court instructed that "Plaintiff's counsel [would] be permitted to read to the jury the questions which Defendant DiBella refused to answer during his investigative interviews . . . . The Court will then instruct the jury that it may, but need not, draw an adverse inference against Defendant based on his refusal to answer, if such an inference is warranted by the facts of the case." *Id.* at *5.

to testify in order "to demonstrate his answers would not have incriminated him."[457] However, the court refused to allow DiBella to testify regarding his reasons for invoking the Fifth Amendment privilege, or to allow his attorney to do the same, absent a waiver of the attorney-client privilege and the attorney's withdrawal from the case.[458]

Several courts have extended the rule and allowed adverse inferences to be drawn against a party from a *non*-party's assertion of the Fifth Amendment privilege. In *LiButti v. United States,*[459] the court held that privilege assertions made by a non-party father were admissible against the plaintiff daughter, who had sued the IRS. In determining that the father's refusals to answer questions were admissible against the daughter, the court considered the following factors: (1) the nature of the relevant relationships; (2) the degree of control of the party over the non-party witness; (3) the compatibility of the interests of the party and non-party witness in the outcome of the litigation; and (4) the role of the non-party witness in the litigation.[460]

---

[457] *Id.* at *4.

[458] *Id.* at *5.

[459] 107 F.3d 110, 124-25 (2d Cir. 1997).

[460] *Id*. at 122-124; *see also Banks v. Yokemick*, 144 F. Supp. 2d 272, 289-290 (S.D.N.Y. 2001) (refusing an adverse inference where there was insufficient information about the nature of the relationships and the degree of control over the non-parties). Several other courts have held that an adverse inference may be drawn from a non-party's assertion. *See, e.g*, *In re High Fructose Corn Syrup Antitrust Litig*., 295 F.3d 651, 663 (7th Cir. 2002) (noting it would have been appropriate to draw an adverse inference against a corporation-defendant from the assertion of privilege of its former employees). However, at least one court has refused to allow evidence that a former co-defendant asserted the Fifth Amendment privilege to be admitted against remaining defendants. *See McGhee v. Joutras*, No. 94 C 7052, 1996 U.S. Dist. LEXIS 18019, at *18-20 (N.D. Ill. Dec. 4, 1996) (also excluding evidence that the former

[Footnote continued on next page]

The court noted that "the overarching concern is fundamentally whether the adverse inference is trustworthy under all of the circumstances and will advance the search for the truth."[461] In *LiButti*, the evidence was found admissible because the non-party (the father) and the plaintiff (the daughter) had close family and business ties and their interests in the lawsuit were aligned, such that the non-party was likely to assert the privilege to avoid harming the plaintiff's case.[462]

2. Exclusion of References to Unrelated Corporate Wrongdoing

Motions *in limine* also may be used to exclude evidence regarding high-profile corporate scandals and lawsuits, such as those involving Enron or WorldCom, as irrelevant and overly prejudicial.[463] In *Sabratek Liquidating LLC v. KPMG LLP*, the court granted KPMG's motion *in limine* to preclude plaintiff from referencing "auditing and reporting irregularities recently reported in the media, such as those relating to Enron and Arthur Andersen" because "the improper conduct of other firms, such as Arthur Andersen, has little, if any, relevance to KPMG's conduct at issue in the

---

[Footnote continued from previous page]
co-defendant had entered into a "Consent and Stipulation" with the SEC, had been indicted, and had settled in the instant action).

[461] *LiButti*, 107 F.3d at 124.

[462] *Id.* at 113, 122-124.

[463] *See*, *e.g.*, *In re WorldCom, Inc. Sec. Litig.*, 02 Civ. 3288 (DLC), 2005 U.S. Dist. LEXIS 2216, at *12-14 (S.D.N.Y. Feb. 18, 2005); *In re WorldCom, Inc. Sec. Litig.*,.02 Civ. 3288 (DLC) 2005 U.S. Dist. LEXIS 3391, at *4-8 (S.D.N.Y. Mar. 7, 2005) (granting motion to exclude evidence of corporate wrongdoing, civil or criminal investigations and litigation); *Schwarz v. System Software Assocs.*, 32 F.3d 284, 289 (7th Cir. 1994) (affirming the exclusion of evidence that defendant's expert witness's company had been involved in the Lincoln Savings and Loan scandal).

present case."[464] The probative value of such wrongdoing was "substantially outweighed" by the risk of unfair prejudice that could be given such evidence by the jury.[465] However, the court denied KPMG's motion to the extent it sought to exclude "any allegations against KPMG involving different clients."[466] Noting that "references to prior bad acts are allowed in certain circumstances pursuant to Federal Rule of Evidence 404(b)," the court found that such evidence was potentially admissible.[467]

Courts also may exclude evidence of new regulations or legislation enacted after the conduct at issue in the case, including the Sarbanes-Oxley Act of 2002, as irrelevant or prejudicial. In *In re WorldCom*, the court granted defendant's motion *in limine* to exclude evidence or argument by plaintiff concerning the Sarbanes-Oxley rules or regulations.[468] Because the conduct at issue in the lawsuit pre-dated the Act's passage, the court found Sarbanes-Oxley irrelevant.[469] Similarly, in *In re Blech Securities Litigation*, the court excluded evidence of a later version of a New York Stock Exchange's Self-Regulatory Organizations Rule because it post-dated the conduct at issue in the case and thus was irrelevant.[470]

---

[464] No. 01 C 9582, 2003 WL 22715820, at *6 (N.D. Ill. Nov. 18, 2003).
[465] *Id.*
[466] *Id.*
[467] *Id.*
[468] No. 02 Civ. 3288 (DLC), 2005 U.S. Dist. LEXIS 3144, at *6 (S.D.N.Y. Mar. 4, 2005).
[469] *Id.*
[470] No. 94 Civ. 7696 (RWS), 2003 U.S. Dist. LEXIS 4650, at *7-11 (S.D.N.Y. Mar. 27, 2003).

3. Exclusion of Evidence or Argument Related to Class Issues

Courts also have used motions *in limine* to limit the use of individualized evidence in the class action setting. In *In re WorldCom*, plaintiffs, who moved to bifurcate the case to separate class-wide and individual issues, also moved to exclude any testimony relating to the named plaintiffs in the class-wide trial.[471] Plaintiffs proposed to reserve a separate trial for individualized knowledge, reliance and damages issues associated with both the absent class members and named plaintiffs.[472] Defendants argued that these witnesses should provide testimony in the main trial on the materiality of the alleged omissions, the sufficiency of disclosures in the registration statements, and the adequacy of the underwriters' due diligence efforts.[473] Defendants also wanted to examine the plaintiffs' financial advisors to show they also had a due diligence obligation to the class, were aware of the same information known to the underwriters, and did not suspect fraud.[474] The court granted the plaintiffs' motion in limine, and ordered that defendants could only take testimony from the named plaintiffs in the later, bifurcated trial on reliance and damages issues, because (1) defendants' arguments really concerned reliance arguments to be addressed later and (2) the financial advisors' testimony would be more prejudicial than probative.[475] A jury would likely confuse the issue of the named plaintiffs' individual reliance, who, as sophisticated investors, would have a higher burden to show justifiable reliance than would the class, thus, there was a

---

[471] *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), 2005 U.S. Dist. LEXIS 2603, at *2-3 (S.D.N.Y. Feb. 22, 2005).
[472] *Id.* at *3.
[473] *Id.* at *4.
[474] *Id.*
[475] *Id.* at *5-6.

danger that the jury would be critical of the named plaintiffs for failing to do their homework and apply that higher burden to the class generally.[476]

Other courts have used motions *in limine* to refine the class definition and streamline liability issues for trial. Defendant Bear Stearns in *In re Blech* moved under Federal Rule of Civil Procedure 23 to modify the class period and moved *in limine* to exclude related evidence from the trial.[477] First, the class period was limited to the period for which the plaintiffs alleged damages. Secondly, the court limited the number of Blech securities at issue, in keeping with the court's earlier ruling on defendant's motion for summary judgment.[478] Third, since Bear Stearns' alleged actions only occurred in the secondary markets, the court held that persons who bought stock in the public offering could not recover from Bear Stearns, particularly where Bear Stearns was not an underwriter and it was not alleged that there was an interrelationship between the public offering and trading in the secondary markets.[479]

4. Evidence of Stock Sales, Allegedly Similar Transactions, or Prior Convictions

Several other courts have limited evidence of defendants' stock sales or of similar transactions as prejudicial or irrelevant. In *Howard v. Everex Systems, Inc.*, the court affirmed the trial court's exclusion of evidence of

---

[476] *Id.* at *12.
[477] *In re Blech Sec. Litig.*, No. 94 Civ. 7696 (RWS), 2003 U.S. Dist. LEXIS 4650, at *44 (S.D.N.Y. Mar. 27, 2003).
[478] *Id*. at *44-45.
[479] *Id*. at *45-46.

defendant's sales of Everex stock.[480] In *Howard*, plaintiff sought to introduce evidence of the stock sales of defendant Hui, the former chairman and CEO, because the sales were "suspicious in time and amount" and thus suggestive of defendant's motive to commit fraud.[481] The court disagreed, finding that the sales could not support a finding of scienter as a matter of law because they were made pursuant to a divestiture program in which the defendant sold the same amount of stock every quarter starting well before the class period.[482] Since the sales were not "dramatically out of line with prior trading practices," they were properly excluded as irrelevant and more prejudicial than probative.[483]

In *Gerber v. Computer Associates International*, plaintiffs sued a corporation that had acquired another corporation, alleging that the company had paid the corporation's chairman and CEO more per share than other shareholders, disguised as consideration for a non-competition agreement.[484] At trial, the defendant corporation sought to introduce evidence of other transactions in which it made substantial payments to other individuals in exchange for non-competition agreements. The trial court admitted little of this evidence – only allowing one witness to testify regarding the existence of non-compete payments in other transactions. However, the details of these other transactions were excluded.[485] The Second Circuit held that the trial court did not abuse its discretion in excluding the bulk of this evidence, finding that the other transactions all differed from each other and the facts of each would have required an

---

[480] 228 F.3d 1057, 1066-67 (9th Cir. 2000).
[481] *Id.*
[482] *Id.*
[483] *Id.* at 1067.
[484] 303 F.3d 126, 128 (2d Cir. 2002).
[485] *Id.* at 136-37.

individual determination.[486] Thus, the court properly excluded the evidence as a waste of time.

When a prior act is, in fact, relevant to the allegations at issue in a case, evidence of that prior act will generally be admitted. The Third Circuit, in an unpublished opinion in *Securities & Exchange Commission v. Johnson*, [487] affirmed the trial court's admission of evidence of the defendant's prior criminal conviction. In *Johnson*, the defendant was accused of committing securities fraud by causing his company to file two registration statements that contained misrepresentations and omissions.[488] The defendant moved *in limine* to exclude evidence that many years earlier, when he was employed by a different company, he had been convicted of misapplication of funds. However, because one of the registration statements at issue indicated that the company "had no record of officers or directors who had been involved in legal proceedings material to an evaluation of their ability or integrity," the prior conviction was itself highly probative evidence that the registration statement contained a misrepresentation.[489]

The motions *in limine* described above are only a sample of potential motions that may be brought on behalf of either plaintiffs or defendants to avoid potential prejudice and juror confusion; others may be suggested by the unique facts of each case.

---

[486] *Id*. at 137.
[487] No. 04-4114, 2006 WL 869162, at *2 (3d Cir. Mar. 24, 2006), *affirming*, No. 02-cv-05490 (D. N.J.).
[488] *Id.* at *1.
[489] *Id.* at *2.

B. Proving Damages in Securities Class Actions

To recover damages in a securities class action, plaintiffs must prove not only that the defendant engaged in fraud, but must also establish how – and to what extent – the defendant's fraud injured unnamed investors. This process of proving damages can be broken down into two parts. First, plaintiffs must show how many of an issuer's shares were affected by the defendant's fraud. Second, they must show the extent to which the fraud inflated the price of each of those shares. Because of the inherent difficulty in establishing either of these elements through direct evidence in a class action setting, plaintiffs often employ expert witnesses to present a theoretical model of damages.

As outlined by the Supreme Court in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,[490] expert testimony is admissible under Rule 702 of the Federal Rules of Evidence only if it satisfies "a standard of evidentiary reliability." *Daubert* set forth a nonexhaustive list of factors that courts could consider in assessing the reliability of expert testimony, including:

1. Whether the expert's theory or technique can be and has been tested;

2. Whether the expert's theory or technique has been subjected to peer review and publication;

3. Whether there is a known error rate for the expert's technique; and

---

[490] 509 U.S. 579, 590 (1993).

4. Whether the expert's theory or technique is generally accepted within the relevant community of experts.[491]

In *Kumho Tire Company, Ltd. v. Carmichael*,[492] the Supreme Court further held that the *Daubert* limitation on expert testimony applies to all expert testimony, not just expert testimony that is scientific in nature. Thus, under *Daubert* and *Kumho*, before expert testimony regarding damages (or any other issue) may be admitted into evidence in a securities fraud case, it must be shown to be sufficiently reliable.

1. Determining the Number of Affected Shares

Assuming a damages "model" is to be used as a basis to assess class wide damages, instead of actual purchase and sale data, the usual first step in calculating total damages under the typical damages model is determining the total number of shares affected by the defendant's fraud. Plaintiffs may recover damages only for those shares that were purchased at prices inflated by the defendant's fraud, and sold at a loss after that fraud was revealed to the market. Such shares sometimes are referred to as the "Affected Shares" or "Damaged Shares." Given the overwhelming complexity involved in examining the trading records for each and every member of a class, plaintiffs often seek to instead rely on statistical models that purport to estimate trading activity, and thus estimate the number of Affected Shares. These models attempt to estimate class damages in the aggregate, rather than summing the known damages of each individual class member. Introduction of these complex

---

[491] *Id*. at 593-94.
[492] 526 U.S. 137, 147 (1999).

statistical models into evidence usually requires the testimony of expert witnesses, and *Daubert*'s requirement of evidentiary reliability thus becomes critical.

As noted above, damages may only be recovered for those shares that were (1) purchased at a price inflated by the defendant's fraud (i.e. during the class period), and (2) sold at a price diminished by the fraud's revelation to the market (i.e. after the class period). Thus, to accurately calculate the number of Affected Shares, the plaintiff must exclude the shares that were either purchased before the fraud occurred, or sold before the fraud was revealed. While determining the total number of shares traded of any particular security on a given day is not difficult, determining precisely *which* shares were traded is more problematic. The overall trading volume for a particular security on a particular day normally will include shares that were both purchased and sold during the class period (and thus for which no damages may be recovered). Plaintiffs have attempted to account for this "in and out" phenomenon by putting forth statistical trading models that purport to estimate the portion of trading volume comprised of such "in and out" shares, and excluding those shares from the computation of damages.

A significant amount of litigation has centered on the use of such trading models, and whether their use complies with *Daubert*'s requirement of evidentiary reliability. Decisions on the issue have been mixed. In *Kaufman v. Motorola, Inc.*,[493] the court held that the trading model offered by the plaintiffs' expert did not meet *Daubert*'s standard of reliability, and granted the defendant's motion to exclude the expert's testimony. In rejecting the model, the court noted that it had not been tested against reality or accepted by professional economists, and noted that the

---

[493] No. 95 C 1069, 2000 WL 1506892, at *2 (N.D. Ill. 2000).

model "seems to be a theory developed more for securities litigation than anything else."[494]

More recently, the Central District of California excluded aggregate damages testimony in *In re Broadcom Corp. Securities Litigation*.[495] Though the court chose not to reach this result directly on *Daubert* grounds, and instead held that an alternative claims administration process was more reliable than the model put forth by plaintiffs, the court noted that the trading model offered by the plaintiffs' expert was "of significantly questionable reliability," and "of questionable accuracy."[496] The court also stated that "the proposed trading model probably does not satisfy the *Daubert* test for submission to the jury. The technique has not been tested against 'real world' conditions . . . It has not been subjected to the sort of critical peer review and publication that one would expect as a prerequisite for jury acceptance. The potential error rate is highly questionable . . ."[497] Finally, the court noted that the model "is not generally accepted in what is the relevant scientific community – professional economists."[498]

Other courts, however, have found that aggregate damages models are sufficiently reliable to merit admission into evidence. The court in *In re WorldCom, Inc. Securities*

---

[494] *Id*.
[495] No. SA CV 01275, 2005 WL 1403756 (C.D. Cal. 2005).
[496] *Id*. at *2.
[497] *Id*.
[498] *Id*. *See also Bell v. Fore Systems, Inc*., No. Civ.A. 97-1265, 2002 WL 32097540 (W.D. Pa. 2002). In *Bell*, the court rejected an aggregate damages model, not on *Daubert* grounds, but because the court found that aggregate damage awards were prohibited under 15 U.S.C. § 78u-4(e), the PSLRA's Limitation on Damages provision. *Id*. at *3-4.

Litigation,[499] for example, noted that aggregate damages awards are "standard practice" in securities cases.

2. Calculating Damages per Share

Once the number of Affected Shares has been determined, plaintiffs must also estimate the amount by which the defendant's fraud inflated the price of each share. An accurate estimate of this figure requires plaintiffs to isolate the impact of the defendant's fraud from other sources of variation in the price of the security, such as broader market trends or the company's disclosure of negative information that is unrelated to the fraud. Plaintiffs' experts generally attempt to measure the fraud-related price inflation of a security by examining how much the security's price changed after the fraud was revealed to the market, usually in the form of a "curative" disclosure made by the company. By examining this change in price, plaintiffs' experts attempt to determine what the price of the security would have been on each day of the class period but for the defendant's fraud.

As with the calculation of the number of Affected Shares, expert testimony usually is offered on this issue. Through the use of "event studies," experts conduct a statistical analysis of the changes in a security's price in an effort to identify public disclosures that might correspond to them. If a price change correlates to a disclosure unrelated to the defendant's fraud, the expert may subtract the effect out of the damages calculation. Courts have repeatedly

---

[499] No. 02 Civ. 3288 DLC, 2005 WL 375314, at *7 (S.D.N.Y. 2005). *See also In re Blech Sec. Litig*., No. 94 Civ. 7696(RWS), 2003 WL 1610775, at *26 (S.D.N.Y. 2003) ("It is the common practice to award an aggregate verdict for the class as a whole."); *In re Cendant Corp. Sec. Litig.*, 109 F. Supp. 2d 235, 272 (D. N.J. 2000) (approving the use of trading models "to create an estimate of aggregate damages" for purposes of allocating proceeds from a settlement fund).

emphasized the necessity of determining how much of a security's price decline is not attributable to fraud. "Use of an event study or similar analysis is necessary . . . to isolate the influences of information specific to [the issuer] which defendants allegedly have distorted." *In re Oracle Sec. Litig.*,[500] 829 Accordingly, several courts have excluded expert testimony where the expert did not perform an event study to account for non-fraud influences on share price. The *Carpe* court, for example, found that "plaintiffs' expert did not perform a proper event study and failed to follow the accepted methodology of his field, making his opinions in this case inherently unreliable."[501] Similarly, the court in *In re Imperial Credit Industries Securities Litigation*[502] held that "[a] proper measure of damages in the securities context . . . requires elimination of that portion of the price decline or price difference which is unrelated to the alleged wrong" and excluded an expert report that contained no event study. [503]

---

[500] F. Supp. 1176, 1181 (N.D. Cal. 1993). *See also Carpe v. Aquila, Inc.*, No. 02-0388-CV-W-FJG, 2005 WL 1138833, at *3 (W.D. Mo. 2005) ("Failure to conduct an event study comparing the stock's price to the market as a whole or a selected index of similar businesses is enough to cause an expert's opinion to be excluded.").

[501] *Id*. at *4.

[502] 252 F. Supp. 2d 1005, 1014-16 (C.D. Cal. 2003).

[503] Outside the class action context, the court in *Morgan Stanley & Co. Inc. v. Coleman (Parent) Holdings, Inc*. recently reversed a jury's $604 million compensatory damage award due to an expert's failure to perform an event study. No. 4D05-2606, 2007 Fla. App. LEXIS 4167, at *19 (Fla. Dist. Ct. App. March 21, 2007). The court noted that "recovering in a securities case requires elimination of that portion of the price decline that is the result of forces unrelated to the wrong . . . Usually, a securities plaintiff proves the actual, or 'fraud-free,' value of the stock at the time of purchase by presenting a expert 'event study' . . ." *Id*. at *14-15 (internal quotations and citations omitted). In reversing the jury's award, the court noted that the plaintiffs' expert "did not isolate the fraud-free price and perform the standard securities analysis to determine what would have been the stock's value on the date of transaction." *Id*. at *10.

3. The Effect of *Dura* on Proof of Class-Wide Damages

The Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*,[504] clearly will have a profound impact on proving damages in future securities class actions that are tried to verdict, and on the admissibility of expert testimony on damages issues at trial. While *Dura* is most directly applicable to pleading requirements in securities cases, the decision may also lead to increased judicial scrutiny of expert testimony regarding damages, since the opinion underscores the plaintiff's burden to isolate the effects of the defendant's fraud from other potential influences on share price. In *Dura*, the Court noted that when a stock price declines following an issuer's corrective disclosure, "that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price."[505] *Dura* held that plaintiffs may not simply plead that plaintiffs bought shares at inflated prices due to the defendant's fraud, but must also provide the defendants with "notice of what the relevant economic loss might be or of what the causal connection might be between the loss and the misrepresentation . . ."[506] Thus, expert testimony that purports to determine damages without taking into consideration how changes in share price might be caused by factors other than the revelation of fraud will likely be met with increased scrutiny.

---

[504] 544 U.S. 336 (2005)

[505] *Id*. at 1632.

[506] *Id*. at 1634.