INSIDE THE MINDS

Securities Litigation and the Economic Crisis

Leading Lawyers on Understanding the Current Legal Environment, Developing Litigation Best Practices, and Helping Clients Respond to a Changing Marketplace

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First Printing, 2009
10 9 8 7 6 5 4 3 2 1

Understanding and Dealing with the Current Securities Litigation Environment

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Introduction

This chapter discusses the current trends in securities litigation in this era of unprecedented financial turmoil. We start with a discussion of the economic and market circumstances behind today's securities fraud claims. We then discuss current trends in securities class action litigation filings, as well as recent rulings in subprime-related cases. We provide an overview of the landmark cases and statutes that have shaped the current securities litigation environment and discuss the role of loss causation in today's securities fraud claims. We then discuss the most important recent securities litigation decisions from the federal appellate courts. Finally, we provide a brief overview of strategies and methods to successfully handle new securities class action lawsuits.

The Current Legal Environment

Economic and Market Circumstances behind Today's Securities Fraud Claims

The past year has been a time of unprecedented financial stress. Events took place in 2008 that were almost unimaginable a year earlier. The financial markets and global economy deteriorated across all asset classes seemingly overnight. More than $10 trillion of value virtually disappeared from the U.S. markets alone, with the S&P 500 down 40 percent in 2008, and the stock market continuing to decline further in early 2009. We witnessed the collapse of venerable financial institutions and the near collapse of many others, the freezing of the credit markets, an unprecedented wave of governmental intervention on a global scale, and the forced combination of several financial institutions, resulting in the disappearance of many old-line names on Wall Street.

We also saw the revelation of financial scandals on an unprecedented scale, with allegations that investment manager Bernard Madoff had engaged in a massive Ponzi scheme resulting in more than $50 billion in losses to investors—many of them individuals who had invested their life savings, and the endowments of charitable institutions. In 2009, there have been further revelations of massive alleged swindles, and we find ourselves in the grips of a deepening global recession, rising unemployment, and widespread layoffs, bankruptcies, and foreclosures. There is no indication that the business climate is likely to recover in the near or medium term.

The first signs of the financial meltdown and global recession appeared in the subprime mortgage crisis during 2007. With interest rates at historic lows, residential real estate investment grew dramatically over the past decade. Subprime lending enabled less creditworthy borrowers to finance their homes. Some lenders focused much of their business on subprime lending. Others included subprime lending as part of a more diversified mix of loans.

Risky underwriting practices also flourished, such as so-called stated income or liar loans that allowed borrowers to represent their income without confirmation. Many loans were also ticking time bombs for borrowers; initial teaser rates were scheduled to reset at higher levels in two to five years, or interest-only payments were replaced after several years by full interest and principal payment requirements. An estimated 80 percent of subprime borrowers received adjustable rate mortgages (ARMs) or hybrid loans. An example of the latter type is the so-called 2/28 or band-aid loan, which was sold with a fixed low rate for the first two years and then became adjustable for the final twenty-eight years.[1]

Borrowers took on these loans, confident that they could sell their homes at a profit or refinance on favorable terms if their incomes did not increase enough to make the higher payments down the road. Some homeowners used their homes as ATMs, using second mortgages and home equity lines of credit made possible by inflated home values to buy cars, boats, and consumer goods.

Securitization—the bundling of loans into pools from which various securities were derived—facilitated the spread of this high-risk financing, allowing mortgage lenders to take loans off their books and pumping additional capital into the mortgage lending markets. Financial institutions significantly increased their investments in mortgage-backed securities, including interests in loan pools, tranches of securities derived from those

[1] *See* Dr. Faten Sabry and Dr. Chudozie Okongwu, *How Did We Get Here? The Story of the Credit Crisis* (Feb. 19, 2009) (available at http://www.nera.com/publication.asp?p_ID=3734).

pools, and interests in collateralized debt obligations (known as CDOs) with underlying mortgage assets. To increase their returns, investment banks in particular took on unprecedented amounts of leverage. Lehman Brothers, for example, had a 30-to-1 debt-to-equity ratio. Derivative instruments such as credit default swaps—essentially, agreements to insure against losses on the mortgage-backed securities—also became widespread, having the effect of spreading the risk even further.

We all know what happened next. Beginning in 2004, interest rates started to rise. Correspondingly, housing price increases began to decelerate. In late 2006 and early 2007, real estate sales started to decline dramatically, as prices had increased well beyond affordability, and easy lending began to dry up. In some markets, buyers practically disappeared. As teaser rates reset at higher levels, and interest-only loans converted to interest and principal, some borrowers could no longer afford their mortgages and went into default and foreclosure. Some simply walked away from homes—and their high mortgage payments—that were now worth less than the money owed on them. Increasing foreclosures further drove down many markets, creating a vicious downward spiral. New home construction, which had done much to buoy the U.S. economy in combination with consumer spending, ground almost to a halt.

Initially, it appeared that the damage would largely be limited to the subprime lending industry. In 2007, former high-profile subprime mortgage lenders such as Ameriquest, Fremont General, New Century Financial, and many others ceased operations and later filed for bankruptcy protection. In early 2008, Countrywide, the nation's largest mortgage lender, was close to failure and ultimately purchased by Bank of America. But the fallout spread beyond subprime mortgage lenders. Although the problem first became evident in the subprime sector, delinquencies and foreclosures of prime loans also soared.[2]

Several factors contributed: (1) lax underwriting standards in recent years; (2) homeowners' increased indebtedness; (3) previously easily available, cheap credit combined with increasing house prices; (4) a decline in housing prices; and (5) increased use of non-traditional mortgage products, such as

[2] *See id.*

hybrid loans with initial teaser rates or initial periods of interest-only payments. These factors were not limited to subprime borrowers, but also affected prime borrowers.[3]

The subprime crisis became a full-blown credit crisis as mortgage delinquencies and foreclosures increased dramatically and financial institutions began to reassess the value of mortgage-backed securities on their books, as well as their exposure to derivative instruments such as credit default swaps. This was in part prompted by new "mark to market" accounting rules in Financial Accounting Standards Board Statement 157 (FAS 157) for assets or liabilities required to be carried on the books at their fair value, including mortgage-backed securities.

Before FAS 157, where it was difficult to determine instruments' market value because they were traded infrequently and privately, they were often "marked to model" (or, as some disparagingly stated, "marked to make-believe") in a hypothetical manner using estimated valuations derived from financial modeling and, often, the value of the instruments at the time of acquisition. By contrast, now FAS 157 requires companies to adjust their valuations to their current market value—the price at which the instruments could be sold at the time of valuation. FAS 157 has been criticized because in a distressed market, like the present one, it is difficult to sell mortgage-backed securities for anything but fire sale prices, which may be below the value that the actual cash flows from the underlying mortgages would merit. The result was that many large financial institutions recognized significant losses in 2007 and 2008 because of marking down their mortgage-backed securities holdings to current market value.

With the dramatic rise in mortgage delinquencies, mortgage-backed securities and related derivatives became known as "toxic assets." Due to their complexity and illiquidity, there was great uncertainty regarding their real value. Compounding that problem were also fears that the true financial condition of institutions was much worse than disclosed because the mortgage-backed securities were held off-balance sheet or had not been marked down sufficiently. Financial institutions became unwilling to transact with one another because of counterparty risk, leading to the

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[3] *Id.*

freezing of credit markets in September and October 2008. The financial crisis reached a crescendo with the failure of Lehman Brothers. Due to fears regarding the solvency of major financial institutions and the impact of the crisis on a worsening recession in the third quarter of 2008, the stock market reacted with dramatic losses and volatility. Many individual investors saw their retirement savings decline by more than 40 percent, and the losses continued in the first quarter of 2009.

An additional feature of the financial crisis was the freezing of the auction rate securities markets in early 2008. Auction rate securities are debt instruments, usually corporate or municipal bonds, with a long-term nominal maturity through which the interest rate is reset in regular auctions, *e.g.*, every seven, twenty-eight, or thirty-five days. They were commonly marketed as low-risk, highly liquid investments with liquidity ensured by the regular auction process, and therefore suitable for short-term investors.

By early 2008, the auction rate securities market had grown to more than $200 billion. Holders of auction rate securities included both institutional investors and individuals. In February 2008, auctions for these securities began to fail when investors declined to bid on them. Concerned about their risk exposure and their need to preserve capital in the midst of the broader financial crisis, the large banks that made a market in auction rate securities declined to act as bidders of last resort. With the securities no longer liquid, broker-dealers wrote down the value of auction-rate securities in investors' accounts. Public companies holding them also undertook write-downs of up to 75 percent of their face value, in accordance with FAS 157.

The federal government reacted to the financial crisis with a series of dramatic bailouts of financial institutions. The Federal Reserve pumped $85 billion into insurance giant AIG and received warrants giving it an 80 percent ownership stake in the company, followed by additional financing bringing the total cost to $150 billion. It put Fannie Mae and Freddie Mac into a government-run conservatorship in exchange for financing up to $100 billion. It provided Citibank with $25 billion in financing and guarantees regarding risky assets. Congress passed the Emergency Economic Stabilization Act of 2008, which authorized the Treasury to spend up to $700 billion to purchase distressed assets (particularly mortgage-backed securities) and to make capital infusions into banks—referred to as the Troubled Assets Relief Program (TARP).

All $350 billion of the first half of the TARP funds released was used for capital injections to prop up teetering U.S. financial institutions, rather than in removing distressed assets from their books. A number of major banks disappeared, with both Washington Mutual and Wachovia collapsing, and being acquired by JP Morgan Chase and Wells Fargo, respectively. Investment banks ceased to exist as such. On the verge of insolvency, Bear Stearns was acquired by JP Morgan Chase, which the Federal Reserve facilitated with a $29 billion non-recourse loan. Lehman Brothers went into bankruptcy. Goldman Sachs and Morgan Stanley transitioned from investment banks to traditional bank holding companies. In February 2009, the Obama administration announced a conceptual plan for a public-private partnership to purchase troubled assets from financial institutions, but the lack of specifics created further uncertainty, and the markets reacted negatively with further declines.

Meanwhile, the fallout spread to the broader economy. The combination of falling consumer confidence and high gas prices resulted in unprecedented declines in automobile purchases, leaving General Motors and Chrysler near bankruptcy and able to survive only with government loans. Decreasing demand for goods and services spread to other sectors of the economy, including manufacturing, retailing, and technology. As a result, Caterpillar, Home Depot, Sprint Nextel, and eight other companies announced on the same day in January 2009 that they would cut more than 75,000 jobs in the United States and around the world. In total, the recession had claimed more than 4 million U.S. jobs by the end of February 2009, and the International Labor Organization predicted that worldwide job losses due to the global recession could hit 50 million by the end of the year.

In February 2009, Congress passed and President Obama signed the Economic Recovery and Reinvestment Act of 2009, intended to provide economic stimulus to the U.S. economy at a cost of $787 billion. But fears that the stimulus package would not be effective in the short or medium term and continued losses in the financial sector, potentially requiring further federal aid to ailing financial institutions, have continued to depress the stock markets.

In his February 24, 2009, address to Congress, President Obama stated that he anticipated additional bank bailouts would be required and that their cost would be more than the $700 billion Congress set aside in fall 2008. Through early March 2009, the S&P 500 had declined another 10 percent (down 25 percent year-to-date), on top of the approximately 40 percent decline in 2008, and many economists were predicting that 2010 would be the earliest the U.S. economy would begin pulling out of the recession.

Current Trends in Securities Fraud Claims

Securities litigation is usually a reflection of the times, with litigation increasing in times of financial crisis and then decreasing in between. Past periods of heightened securities litigation activity have included the savings and loan crisis and the related deterioration in the financial and real estate markets of the late 1980s and early 1990s; the bursting of the dot-com bubble, along with the revelation of massive accounting scandals at Enron, WorldCom, and other companies in 2000-2002; and the stock-option backdating scandals of the mid-2000s. It is therefore not surprising that in light of the current financial crisis, the present trend in securities fraud litigation features subprime and credit crisis-related lawsuits.

By late February 2009, plaintiffs had filed more than 161 securities class action lawsuits related to the subprime and credit crisis.[4] With 210 total filings, the highest level since 2004, new federal securities class actions in 2008 increased almost 20 percent over 2007.[5] Almost half of the new filings in 2008 were against financial institutions and were related to the subprime and credit crisis, and twenty-one of these were filed on behalf of purchasers of auction rate securities.[6] Perhaps even more telling, during the eighteen months before January 1, 2009, there were a total of 317 new securities class action filings—a 71 percent increase over the 185 filings during the prior eighteen-month period—and 40 percent of those filings were related

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[4] *See* The D&O Diary, *Counting the Subprime Lender Lawsuits* (Feb. 23, 2009) (available at http://www.dandodiary.com/2007/04/articles/securities-litigation/counting-the-subprime-lender-lawsuits/index.html).

[5] Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research, *Securities Class Action Filings 2008: A Year in Review* at 1, 4 (Jan. 2009) (available at http://securities.stanford.edu) ("*2008 Year in Review*").

[6] *Id.*

to the subprime and credit crisis.[7] Over the same period, filings unrelated to the subprime and credit crisis grew only 8 percent.[8] Filings related to options backdating, the prior wave of securities class action litigation, declined to only four in 2008.[9] In a sign of the severity of the financial crisis and its impact on litigation, even the former chief executive officer (CEO) of AIG, Hank Greenberg, has sued his former company for alleged securities fraud.

According to one leading securities litigation scholar, Professor Joseph Grundfest of Stanford Law School, "This level of litigation intensity against a single industry is unprecedented since the passage of the 1995 Reform Act."[10] Nearly a third of all large financial institutions—representing more than half of the financial sector's total market capitalization—were sued in a securities class action filed in 2008.[11] Combining 2007 and 2008, institutions representing two-thirds of the financial sector's market capitalization were the subject of a federal securities class action filing.[12] Overall, 9.2 percent of companies in the S&P 500 were defendants in a federal securities class action filed in 2008.[13]

Notably, despite the dramatic decline and volatility of the stock market in the fourth quarter of 2008—factors historically correlated with an increase in litigation activity—the pace of filings did not increase. The number of fourth-quarter filings was about the same as the third quarter of 2008, and it was lower than in the three quarters before that.[14]

Two possible explanations have been offered. The first is that market volatility was so great in the fourth quarter of 2008 that plaintiffs found it difficult to isolate company-specific stock movements that they could allege were the result of fraud from the broader swings of the market, which could

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[7] *Id.* at 4.
[8] *Id.*
[9] *Id.* at 3.
[10] Press Release dated Jan. 6, 2009, "Litigation against Financial Services Firms Dominates Securities Class Action Filings According to Annual Report by Stanford Law School and Cornerstone Research" (available at http://securities.stanford.edu).
[11] *2008 Year in Review* at 2.
[12] *Id.*
[13] *Id.* at 7.
[14] *Id.* at 5.

move as much as 5 percent in a single day.[15] This potential cause is a direct result of the Supreme Court's decision in *Dura Pharmaceuticals Inc. v. Broudo,* 544 U.S. 336 (2005), which held that a decline in stock price alone is not sufficient to plead or prove the required element of loss causation in a securities fraud claim. Rather, the Supreme Court held in *Dura* that plaintiffs must plead and prove a causal connection between the stock price decline and a misrepresentation by the defendant. In other words, they must show that the misrepresentation—and not, for example, broader market movements—caused the loss.[16]

The second possible explanation for the plateau in filings, posited by Professor Grundfest, is that the financial institutions with the deepest pockets have already been sued.[17] Nine out of the largest ten financial institutions in the S&P 500 and twelve of the top fifteen had been sued by the end of 2008.[18] The numbers thin out down the list. For example, in the next twenty-five financial institutions, just nine were sued. According to Professor Grundfest, "that most of the lawsuits filed in 2008 were concentrated among the largest financial institutions may indicate a rational strategy by plaintiff law firms to initially focus on defendants with the deepest pockets."[19]

The extent to which new cases are filed against financial institutions other than the very largest remains to be seen. But initial indications are that the pace is picking up and that 2009 may feature an even greater number of subprime and credit crisis-related lawsuits than 2008. In the first two months of 2009, approximately twenty such lawsuits were filed. If the filings continue at the same or a greater pace, they will surpass the 101 subprime and credit-crisis related lawsuits filed in 2008.[20]

Another notable feature of the current litigation environment is that a greater portion of subprime and credit crisis-related cases have involved claims under Sections 11 and 12(a)(2) of the Securities Act of 1933, which provide for

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[15] *Id.* at 3.
[16] *Id.* at 346-47.
[17] *2008 Year in Review* at 9.
[18] *Id.*
[19] *Id.*
[20] *See* The D&O Diary, *Counting the Subprime Lender Lawsuits* (Feb. 23, 2009) (available at http://www.dandodiary.com/2007/04/articles/securities-litigation/counting-the-subprime-lender-lawsuits/index.html).

causes of action for misrepresentations in registration statements and prospectuses. The advantage for plaintiffs in bringing these 1933 Act claims is that—unlike a fraud claim under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, promulgated thereunder—they do not require pleading and proving the elements of scienter, *i.e.*, intent to defraud, and reliance. The share of class actions alleging 10b-5 claims dropped from 80 percent in 2007 to 75 percent in 2008, contrasted with the previous five years, in which more than 85 percent of filings included 10b-5 claims.[21] Section 11 and 12(a)(2) claims increased from 19 percent to 23 percent and 11 percent to 19 percent, respectively, from 2007 to 2008. In the previous five years, Section 11 claims never reached higher than 12 percent, and Section 12(a)(2) claims never reached 10 percent.[22]

Additionally, plaintiffs have shown an apparent interest in bringing these 1933 Act suits in state court. Over the past decade, Congress has attempted to steer securities class action litigation to the federal courts. It enacted the Securities Litigation Uniform Standards Act (SLUSA) in 1998, which amended the 1933 and 1934 Acts to preempt class actions alleging fraud under state law in connection with the purchase or sale of covered securities. It also enacted the Class Action Fairness Act (CAFA) in 2005, giving federal courts exclusive jurisdiction over class actions involving more than one hundred investors, where the amount in controversy exceeds $5 million, and any class members are residents of a state different from any defendant.

But plaintiffs in several subprime cases have filed class actions in state court alleging misrepresentations in connection with the issuance of subprime mortgage-backed securities.[23] They have argued that their 1933 Act claims should stay in state court pursuant to 1933 Act Section 22(a) (15 U.S.C. § 77v(a)), which provides that actions brought in state court under the 1933 Act may not be removed to federal court.

[21] *2008 Year in Review* at 21.
[22] *Id.*
[23] *See* Kevin LaCroix, *Section 11 Lawsuits: Coming Soon to a State Court Near You?*, The D&O Diary, July 21, 2008, www.dandodiary.com/2008/07/articles/securities-litigation/section-11-lawsuits-coming-soon-to-a-state-court-near-you/ ; *see also* Kevin LaCroix, *Forum Selection and '33 Act Subprime Lawsuits*, The D&O Diary, December 8, 2008, www.dandodiary.com/2008/12/articles/subprime-litigation/forum-selection-and-33-actsubprime-lawsuits/.

The circuit courts have split on the issue of whether such claims are removable. The Ninth Circuit held in *Luther v. Countrywide Home Loans LP,* 533 F.3d 1031, 1034 (9th Cir. 2008), that claims brought exclusively under the 1933 Act for alleged misrepresentations regarding the value of mortgage-backed securities were not removable under CAFA because of Section 22(a). By contrast, the Seventh Circuit, in a well-reasoned opinion by Judge Easterbrook, recently held in *Katz v. Gerardi,* 552 F.3d 558 (7th Cir. 2009) that a 1933 Act claim falling under CAFA is removable despite Section 22(a). Judge Easterbrook concluded that because CAFA expressly identifies those securities class action claims that are not removable (and therefore implies that all others are removable), CAFA trumps Section 22(a) (*Id.* at 562). Similar to the Seventh Circuit, the Southern District of New York in *New Jersey Carpenters Vacation Fund v. HarborView Mortgage Loan Trust 2006-4*, 581 F. Supp. 2d 581 (S.D.N.Y. 2008), held that the removal power under CAFA supersedes Section 22(a) because CAFA does not provide an exception for cases that prior acts of Congress excluded from removal and that it was Congress' intent to provide for removal of all securities claims except for those CAFA expressly exempts (*Id.* at 590).

Although twenty-one auction rate securities lawsuits were filed in 2008, financial institutions' settlements with the SEC and state attorneys general may take some of the wind out of private plaintiffs' sails. Citigroup was the first to settle, and its settlement became the model for those that followed.[24] It agreed to repurchase at par approximately $7 billion worth of ARS it sold to individuals, charities, and small businesses and, for those that sold the ARS at a loss, to pay them the difference between par and the price at which they sold the securities. Additionally, Citigroup agreed to a special arbitration process administered by FINRA to resolve such customers' consequential damages claims. Citigroup also agreed to use its best efforts to offer liquidity solutions to its institutional investors.[25] Shortly thereafter, a number of other financial institutions entered into

[24] *See* Press Release, Securities and Exchange Commission, *Citigroup Agrees in Principle to Auction Rate Securities Settlement* (Aug. 7, 2008), www.sec.gov/news/press/2008/2008-168.htm.

[25] Press Release, Securities and Exchange Commission, *SEC Finalizes ARS Settlements with Citigroup and UBS, Providing Nearly $30 Billion in Liquidity to Investors* (Dec. 11, 2008), www.sec.gov/news/press/2008/2008-290.htm

similar settlements.[26] These settlements call into question the viability of pending and future private securities class action claims related to ARS, at least with respect to individual investors, as there would be no damages to recover if the class members have been made whole.

Because so many subprime cases are relatively new, there have been relatively few decisions regarding whether these suits may proceed beyond the pleading stage. It often takes several months or more for the appointment of lead plaintiffs and their counsel and for the filing of a consolidated complaint upon which the case will proceed before a motion to dismiss is briefed and heard. Although it may be too early to accurately predict any trends, the initial rulings indicate that attacks on the sufficiency of the plaintiffs' scienter allegations may be successful in defeating many of these claims. In several recent decisions in subprime-related cases, district courts have held that plaintiffs failed to plead facts giving rise to a strong inference of scienter under the standard established in the Supreme Court's *Tellabs* decision.[27] Additionally, loss causation may be an effective defense. The stock price of many financial institutions that owned or sold mortgage-backed securities had been falling for months or years before the market as a whole reacted significantly to the subprime mess in the fall of 2008,

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[26] *See, e.g.*, Press Release, Securities and Exchange Commission, *UBS Securities LLC and UBS Financial Services Inc. Agree in Principle to Auction Rate Securities Settlement* (Aug. 8, 2008) (available at www.sec.gov/news/press/2008/2008-171.htm); Press Release, Securities and Exchange Commission, *Wachovia Agrees to Preliminary Auction Rate Securities Settlement That Would Offer Approximately $9 Billion to Investors* (Aug. 15, 2008) (available at www.sec.gov/news/press/2008/2008-176.htm); Press Release, Securities and Exchange Commission, *SEC Enforcement Division Announces Preliminary Settlement with Merrill Lynch to Help Auction Rate Securities Investors* (Aug. 22, 2008) (available at www.sec.gov/news/press/2008/2008-181.htm); Press Release, Securities and Exchange Commission, *SEC Division of Enforcement Announces ARS Settlement in Principle with RBC Capital Markets Corp.* (Oct. 8, 2008) (available at www.sec.gov/news/press/2008/2008-246.htm); Press Release, Securities and Exchange Commission, *Bank of America Agrees in Principle to ARS Settlement* (Oct. 8, 2008) (available at www.sec.gov/news/press/2008/2008-247.htm); Press Release, Securities and Exchange Commission, *SEC Finalizes ARS Settlements with Citigroup and UBS, Providing Nearly $30 Billion in Liquidity to Investors* (Dec. 11, 2008) (available at www.sec.gov/news/press/2008/2008-290.htm .)

[27] *See Tripp v. Indymac Fin. Inc.*, 2007 WL 4591930 (C.D. Cal. Nov. 29, 2007); *Patel v. Parnes*, 253 F.R.D. 531 (C.D. Cal. 2008); *Hubbard v. Atlantic Bancorp Inc.*, 2008 WL 5250271 (S.D. Fla. Dec. 12, 2008); *In re 2007 NovaStar Fin. Inc. Sec. Litig.*, 2008 WL 2354367 (W.D. Mo. June 4, 2008); *In re Impac Mortgage Holdings Inc. Sec. Litig.*, 554 F. Supp. 2d 1083 (C.D. Cal. 2008); *Pittleman v. Impac Mortgage Holdings Inc.*, 2009 U.S. Dist. LEXIS 18213 (C.D. Cal. March 9, 2009).

potentially complicating plaintiffs' burden of pleading and proving that a subsequent revelation of adverse information caused plaintiffs' economic losses.

In many cases, plaintiffs have challenged statements made about the quality or integrity of a company's loan portfolio, underwriting practices, and internal controls. Courts have long regarded statements touting a company's business as immaterial "puffery" on which no investor would rely.[28] Courts also have long rejected attempts to dress up allegations of corporate mismanagement into a securities claim.[29] Consistent with this case law, the courts in *New York State Teachers' Retirement Sys. v. Fremont General Corporation*, *In re 2007 NovaStar Financial Inc. Securities Litigation*, *In re Impac Mortgage Holdings Inc. Securities Litigation*, and *Tripp v. IndyMac Financial*

[28] *See, e.g.*, *In re Ford Motor Co. Sec. Litig.*, 381 F.3d 563, 570-71 (6th Cir. 2004) ("All public companies praise their products and objectives. Courts everywhere have demonstrated a willingness to find immaterial as a matter of law a certain kind of rosy affirmation commonly heard from corporate managers and numbingly familiar to the marketplace."); *Lasker v. New York State Elec. & Gas Corp.*, 85 F.3d 55, 59 (2d Cir. 1996) (statement that a company refused to "compromise its financial integrity" constituted "precisely the type of 'puffery' that this and other circuits have consistently held to be inactionable"); *Ladmen Partners Inc. v. Globalstar Inc.*, 2008 WL 4449280, at *13 (S.D.N.Y. Sept. 30, 2008) (dismissing claim based on company's statement regarding the "high quality" of its products); *In re American Bus. Fin. Servs. Inc. Sec. Litig.*, 413 F. Supp. 2d 378, 400 (E.D. Pa. 2005) (dismissing claim based on statement regarding company's "focus on credit quality"); *Wenger v. Lumisys Inc.*, 2 F. Supp. 2d 1231, 1245-46 (N.D. Cal. 1998) (dismissing claim based on company's statement regarding "high quality product offerings"); *Allison v. Brooktree Corp.*, 1998 WL 34074832, at *5 (S.D. Cal. Nov. 27, 1998) (dismissing claim based on company's statement regarding its "high quality computer products"); *Weill v. Dominion Resources Inc.*, 875 F. Supp. 331, 336 (E.D. Va. 1994) ("[T]he Court simply cannot conclude that any reasonable investor would consider either statement to be meaningful in making an investment decision. 'Compliance with domestic laws,' conducting one's affairs with the 'highest standards of personal and corporate conduct,' and 'full disclosure of public information' are mere characterizations of any lawful corporation. There is nothing extraordinary about these characterizations. If a corporation such as Dominion did not publish such 'touting' statements, it is incomprehensible that a reasonable investor would alter his or her opinion of the corporation.").

[29] *See, e.g.*, *In re Acito v. IMCERA Group Inc.*, 47 F.3d 47, 53 (2d Cir. 1995) ("Section 10(b) was not designed to regulate corporate mismanagement."); *In re Citigroup Inc. Sec. Litig.*, 330 F. Supp. 2d 367, 377 (S.D.N.Y. 2004) (dismissing securities complaint because "[t]he securities laws were not designed to provide an umbrella cause of action for the review of management practices"), *aff'd sub nom.*, *Albert Fadem Trust v. Citigroup Inc.*, 165 F. App'x 928 (2d Cir. 2006) *Ciresi v. Citicorp.*, 782 F. Supp. 819, 821 (S.D.N.Y. 1991) ("[A]llegations of mismanagement are not actionable under section 10(b) of the federal securities laws."), *affd*, 956 F.2d 1161 (2d Cir. 1992).

Inc. rejected attempts to hold companies liable for alleged misleading statements praising the quality or integrity of their businesses.[30]

However, in cases such as *In re Countrywide Financial Corporation Securities Litigation*, *In re New Century*, *In re RAIT Financial Trust Securities Litigation*, and *Atlas v. Accredited Home Lenders Holding Co.*, the courts have allowed claims based on statements touting the quality or integrity of a company's loan portfolio, underwriting practices, or internal controls to survive motions to dismiss.[31] In *Countrywide*, the court candidly acknowledged that in most cases such statements would not be actionable, but felt that it was compelled to make an exception because Countrywide's business practices allegedly departed so far from any reasonable interpretation of "quality" or "standards."[32] Similarly, in *New Century*, the court held that "New Century's statements that it observed standard of high-quality credit and underwriting" were actionable in light of "detailed allegations of practices that utterly failed to meet those standards."[33] In *RAIT*, the court stated that "[w]e cannot say that a statement claiming that RAIT's 'credit underwriting process involves an extensive due diligence process' is mere puffery when Plaintiffs allege that RAIT 'did not conduct any meaningful ongoing credit analysis whatsoever.'"[34] In *Accredited*, the court held that statements regarding the company's underwriting practices were actionable where there was an alleged "widespread deviation from company policy" (556 F. Supp. 2d at 1154-56). As the rulings in *Countrywide*, *New Century*, *RAIT*, and *Accredited* show, courts may be willing to indulge theories they ordinarily would not when presented with extraordinary factual allegations regarding a defendant in the subprime industry.

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[30] *Fremont*, 2008 WL 4812021, at *5; *NovaStar*, 2008 WL 2354367, at *2-3; *Impac*, 554 F. Supp. 2d at 1096; *Indymac*, 2007 WL 4591930, at *3-4.

[31] *In re Countrywide Financial Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1153-54 (C.D. Cal. 2008); *In re New Century*, 588 F. Supp. 2d 1206, 1225-26 (C.D. Cal. 2008); *In re RAIT Financial Trust Sec. Litig.*, 2008 WL 5378164, at *5-6 (E.D. Pa. 2008); *Atlas v. Accredited Home Lenders Holding Co.*, 556 F. Supp. 2d 1142, 1154-56 (S.D. Cal. 2008).

[32] *Countrywide*, 588 F. Supp. 2d at 1144 (citations omitted).

[33] *New Century*, 588 F. Supp. 2d at 1226. The *New Century* decision may be distinguishable from other subprime cases that are litigated at the pleading stage because the court placed heavy reliance on the findings in an extensive Bankruptcy Examiner's Report.

[34] *RAIT*, 2008 WL 5378164, at *6.

Finally, it is worth remembering that while there has been a dramatic increase in securities litigation against financial institutions because of the current financial crisis, half of the new lawsuits in 2008 were still against non-financial companies. Industrial, consumer non-cyclical, and technology companies experienced the greatest number of filings outside of the financial sector.[35] One study found that filings in the industrial and consumer non-cyclical sectors had greater "disclosure dollar loss"—the change in a company's market capitalization between the day before and the day after the end of the class period, which almost always corresponds to the time of an alleged "corrective disclosure"—than the financial sector.[36]

Landmark Cases and Statutes that Have Shaped the Current Environment

Any discussion of the landmark cases and statutes that have shaped the current environment must start with *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), in which the Eastern District of Pennsylvania in 1946 first recognized an implied private right of action similar to common law fraud under Section 10(b) of the 1934 Act and SEC Rule 10b-5. The implied right of action has been referred to as a "judicial oak which has grown from little more than a legislative acorn."[37] Many courts subsequently adopted the *Kardon* holding, including the Supreme Court in *Superintendent of Insurance v. Bankers Life & Casualty Co.,* 404 U.S. 6, 13 n.9 (1971).

Claims under Section 10(b) and Rule 10b-5 have since become the most common type of securities litigation, as the express rights of action under Sections 11 and 12(a)(2) of the 1933 Act are limited to misrepresentations to investors who purchased in public offerings of securities (*e.g.*, Section 11 applies to misrepresentations in a registration statement). Section 10(b) and Rule 10b-5 claims may be brought in connection with misrepresentations made in 1934 Act annual and quarterly reports, in press releases, or in any public statements by the company. The scope of the private right of action was not unlimited, however. In 1975, the Supreme Court limited standing to actual purchasers and sellers of the company's securities in *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975). In 1976, it held in *Ernst &*

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[35] *See 2008 Year in Review* at 18.
[36] *See id.*
[37] *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 737 (1975).

Ernst v. Hochfelder that a private cause of action for damages would not lie under Section 10(b) and Rule 10b-5 in the absence of any allegation or proof of "scienter," *i.e.,* intent to deceive, manipulate, or defraud on the defendant's part (425 U.S. 185 (1976)).

The Supreme Court's 1988 decision in *Basic Inc. v. Levinson,* 485 U.S. 224 (1988) is most responsible for making securities class action litigation the powerful force that it is today.[38] In *Basic*, the Court adopted a presumption that the element of reliance is established in a Section 10(b) and Rule 10b-5 case where the securities at issue were traded in an open and developed market. The Court reasoned that "[t]he modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases[.]"[39] The fraud-on-the-market theory is based on the hypothesis that the price of a company's stock is determined by the material information publicly available regarding the company. "Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements."[40] By generally dispensing with the need to show individual investors' reliance, the presumption of reliance under *Basic* made class action litigation under Section 10(b) and Rule 10b-5 possible.

In 1994, the Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) limited liability to primary violators, holding that there is no aiding and abetting claim in a private action under Section 10(b) and Rule 10b-5.[41] The Court recently reaffirmed the holding of *Central Bank* in its 2008 *Stoneridge* decision, which rejected the imposition of "scheme liability" against secondary actors. In *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 128 S. Ct. 761 (2008), the Court held that vendors who allegedly assisted a company in defrauding its auditors did not make any statements or engage in any conduct that investors or the market relied upon and therefore could not be held liable.

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[38] *Basic Inc. v. Levinson,* 485 U.S. 224 (1988).
[39] *Id.* at 243-44.
[40] *Id.* at 242 (citation omitted).
[41] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

Another landmark event in the history of securities litigation was Congress's enactment of the Private Securities Litigation Reform Act (PSLRA) in 1995. The PSLRA was intended to curb perceived abuses in private securities litigation. Among other things, it imposed heightened pleading requirements, assigned to plaintiffs the burden of demonstrating loss causation, imposed a stay of discovery during the pendency of motions to dismiss, created a safe harbor for forward-looking statements, and imposed a presumption that the role of lead plaintiff should be held by those whose claims involve the most shares, which has resulted in institutional investors such as pension funds and labor unions becoming lead plaintiffs, rather than the small investors beholden to plaintiffs' counsel of the past.

Notably, the PSLRA provides that plaintiffs must plead false statements with a high degree of particularity, i.e., for each statement alleged to have been misleading, the reason or reasons it was misleading, and if made on information and belief, the complaint must state with particularity all facts on which that belief is formed (15 U.S.C. § 78u-4(b)(1)). Additionally, the PSLRA requires plaintiffs to state with particularity facts giving rise to a "strong inference" that the defendant acted with scienter (15 U.S.C. § 78u-4(b)(2)). This requirement has frequently proven difficult for plaintiffs to overcome because, without the benefit of discovery, plaintiffs often do not have access to witnesses or documents that might prove the defendant's state of mind in making the false statement.

One of the consequences of the PSLRA was that many plaintiffs sought to avoid its requirements by filing state-law based securities class action claims in state court. Congress responded by enacting the Securities Litigation Uniform Standards Act (SLUSA) in 1998. SLUSA was intended to curtail the flow of securities litigation from federal to state courts and to prevent state-law based securities class actions from being used to frustrate the PSLRA's objectives. SLUSA provides that no state-law based securities class action may be maintained in state or federal court in which damages are sought on behalf of more than fifty persons involving a security listed on a national stock exchange (*See* 15 U.S.C. § 78bb(f)(1)). Additionally, it provides that such covered class actions filed in state court are removable to federal court (*See* 15 U.S.C. § 78bb(f)(2)).

In 2005, the Supreme Court considered the issue of loss causation in *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336 (2005). It held that a decline in stock price alone is not sufficient to plead or prove the required element of loss causation in a securities fraud claim. Plaintiffs must plead and prove a causal connection between the stock price decline and a misrepresentation by the defendant. In other words, they must show that the misrepresentation—and not, for example, broader market movements—caused the loss. The Court's holding in *Dura* has had a significant impact on securities litigation at all significant stages of a case: motions to dismiss, class certification, summary judgment, and trial.

In 2007, the Supreme Court in *Tellabs Inc. v. Makor Issues & Rights Inc.*, 127 S.Ct. 2499 (2007) took up the issue of what plaintiffs must do to satisfy the PSLRA's requirement that they plead facts giving rise to a "strong inference" of scienter.[42] The PSLRA left the term "strong inference" undefined, and the circuit courts split on what it required, which frustrated Congress's intent to have a uniform pleading standard. For example, the Seventh Circuit, where *Tellabs* originated, held that the strong inference standard is met where a reasonable person could infer from the facts alleged that the defendant acted with the required intent. Other circuits, such as the Sixth and Ninth Circuits, held that the court must also consider inferences in favor of the defendant and that a strong inference is established only where plaintiffs have shown that their inferences are more plausible than the defendants' competing inferences.[43]

The Supreme Court in *Tellabs* held that courts faced with motions to dismiss Section 10(b) and Rule 10b-5 claims must take into account plausible competing inferences. The Court stated that "[t]o 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."[44] It rejected, however, the stricter pleading requirement of the Sixth and Ninth Circuits that the inference of scienter must be the most plausible of competing inferences. It held that a complaint will survive "if a reasonable person would deem the inference of scienter cogent and at least

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[42] *Tellabs Inc. v. Makor Issues & Rights Inc.*, 127 S.Ct. 2499 (2007).
[43] *Id.*, 127 S.Ct. at 2506.
[44] *Id.* at 2510.

as compelling as any opposing inference one could draw from the facts alleged."[45] Thus, while *Tellabs* heightened the bar in circuits such as the Seventh, it lowered the bar in others by shifting a "tie goes to the defendants" standard to a "tie goes to the plaintiffs." Although the defense bar was initially optimistic that *Tellabs* would result in more dismissals, the anecdotal evidence is that it has had less impact than expected.

Finally, a discussion of landmark events that shaped the current environment would not be complete without mentioning what has been referred to as the "Enron Effect." Following the wave of corporate scandals in the early 2000s, most notably Enron and WorldCom, a number of studies found that the public—*i.e.*, potential jurors—had become much more suspicious of the conduct of corporations and their executives. Rather than viewing corporations and their executives as generally honest and respectable members of the community, the public overwhelmingly viewed the conduct in Enron and WorldCom not as isolated, but rather as the "tip of the iceberg" and symptomatic of a broader epidemic of corporate fraud and misconduct.[46] Such attitudes are certainly even stronger in the current financial crisis—what might be called the "Wall Street Effect"—following stories of the high compensation and bonuses Wall Street executives received while their companies collapsed under their leadership, while those on "Main Street" have lost half of their retirement savings and many have lost their jobs as well. The public's anger toward Wall Street has been heightened even further by massive taxpayer-funded government bailouts.

Role of Loss Causation in Today's Fraud Claims

Following *Dura*, loss causation has taken on much greater significance at each of the stages of a securities class action case. *Dura* itself was a pleading case. The plaintiffs argued that they had adequately pleaded the required element of loss causation by alleging in the complaint that the price of the security was inflated on the date of purchase by defendants' misrepresentations.[47] Although the Ninth Circuit had held this was sufficient, the Supreme Court reversed. The Court explained that "[w]hen

[45] *Id.*
[46] *See, e.g.*, DecisionQuest, "*Grappling with "The Effect" of Enron/Worldcom*" (available at http://www.decisionquest.com/litigation_library.php?NewsID=132).
[47] *See Dura*, 544 U.S. at 338.

the purchaser subsequently resells such shares, even at a lower price, 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."[48]

The Supreme Court held in *Dura* that plaintiffs must plead and prove actual proximate causation and economic loss—for example, that the "share price fell significantly after the truth became known."[49] *Dura* requires plaintiffs to identify specific stock price declines, independent of broader market or industry-wide stock price movements, connected to the alleged disclosure of a fraud. It has raised the pleading bar significantly, and a recent study posits that the "uptick in dismissals in recent years may be related to increased pleading standards in the wake of the *Dura* decision by the Supreme Court."[50]

Following *Dura*, loss causation also has become a matter of significant contention at the class certification stage. The Fifth Circuit held in *Oscar Private Equity Investments v. Allegiance Telecom Inc.,* 487 F.3d 261 (5th Cir. 2007) that plaintiffs must establish loss causation at the class certification stage to trigger the fraud-on-the-market presumption of reliance established in the Supreme Court's *Basic, Inc v. Levinson,* 485 U.S. 224 (1988) decision. The fraud-on-the-market theory supplies a blanket presumption that each class member has satisfied the reliance element of their 10b-5 claim. Under *Basic*, any showing that severs the link between the alleged misrepresentation and the stock price, however, is sufficient to rebut the presumption of reliance.[51]

Examples include a lack of market response to the alleged misrepresentations, that the market was aware the misrepresentations were false, or that investors would have purchased or sold the securities even with full knowledge of the misrepresentation.[52] Thus, in "mixed bad news" situations—a common scenario where alleged corrective disclosures are

[48] *Id.* at 342-43.
[49] *Id.* at 346-47.
[50] *2008 Year in Review* at 17.
[51] *Basic, Inc v. Levinson,* at 248.
[52] *Id.*

made concurrently with unrelated bad news—plaintiffs should be required to first make an evidentiary showing that there is a reasonable likelihood that the cause of the decline in price is due to disclosure of the alleged fraud and not the release of the unrelated negative information.[53] The court recognized that without the presumption of reliance, questions of individual reliance predominate, and the proposed class fails.[54]

The Fifth Circuit reasoned in *Oscar* that although *Basic* placed the burden of rebutting the fraud-on-the-market presumption of reliance on defendants, plaintiffs nevertheless should have the initial burden of demonstrating loss causation at the class certification stage because they must demonstrate materiality, i.e., proof that the alleged misrepresentation actually moved the market.[55] The court also found it appropriate to impose such an initial burden on plaintiffs because of the *in terrorem* power of class certification, the extraordinary leverage bestowed upon plaintiffs with certification, and the due process rights of the parties.[56] The court further observed that plaintiffs must demonstrate loss causation in "an empirically based inquiry, not speculation about materiality alone," thus requiring plaintiffs to reveal their damages model and submit supporting expert testimony.[57] Plaintiffs have criticized *Oscar*, arguing that it flips the burden under the fraud-on-the-market theory. Regardless of *Oscar*, however, defendants can rebut the presumption of reliance under *Basic* by submitting evidence showing an absence of loss causation.[58]

The Tenth Circuit's recent decision in *In re Williams Sec. Litig.*[59] is an example of the importance of loss causation at the summary judgment stage. *Williams*, a case in which our law firm (and co-author Wayne Smith) represented the Williams Companies, also involved a mixed bad news scenario—i.e., where disclosures of the alleged fraud are mixed with

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[53] *See id.* at 265; see also *Greenberg v. Crossroads Systems Inc.,* 364 F.3d 657, 666 (5th Cir. 2004).
[54] *Oscar*, 487 F.3d at 264.
[55] *Id.* at 265.
[56] *See id.* at 266-67.
[57] *Id.* at 270.
[58] *See, e.g., Ryan v. Flowserve Corp.*, 245 F.R.D. 560, 569 n.12 (N.D. Tex. 2007) (denying class certification regardless of holding in *Oscar* "because the Flowserve Defendants have submitted a plethora of admissible evidence, particularly with event studies and analyst reports," rebutting the fraud-on-the-market presumption of reliance.)
[59] *In re Williams Sec. Litig.,* --- F.3d ---, 2009 WL 388048 (10th Cir. Feb. 18, 2009).

unrelated bad news. We simultaneously filed a motion for summary judgment and a motion to exclude the testimony of plaintiffs' expert on loss causation. The district court held that the expert's testimony was unreliable under *Daubert* because his theories of loss causation could not distinguish between loss attributed to the alleged fraud and loss attributable to non-fraud related news and events.[60] The court granted our motion for summary judgment because, as a result of the exclusion of the loss causation expert's testimony, the plaintiffs were left with no evidence of a causal connection between the alleged misrepresentations and the decline in value of Williams' stock, an essential element of their claim.[61]

The Tenth Circuit affirmed, holding that under *Dura*, "[t]he plaintiff bears the burden of showing that his losses were attributable to the revelation of the fraud and not the myriad other factors that affect a company's stock price."[62] The court found that the theories of loss causation that plaintiffs' expert advanced failed to identify the mechanism by which fraud was allegedly revealed to the market. It explained that "[t]hough he points to four disclosures, he simultaneously concedes that the market knew of the misrepresentations even before those disclosures, and also makes no account for the fact that these disclosures contained non-fraud related information that would have also affected [Williams'] value."[63] Because plaintiffs failed to present evidence showing that the declines in price were the result of the revelation of the truth and not some other factor, the Tenth Circuit affirmed the grant of summary judgment in Williams' favor.[64]

A case in which this chapter's co-author Wayne Smith was lead trial counsel, *In re Apollo Group Inc. Sec. Litig.*,[65] is an example of the continuing importance of loss causation at trial. In *Apollo*, the plaintiffs claimed they were damaged by Apollo's alleged misrepresentations related to a Department of Education (DOE) program review report that preliminarily found that Apollo's wholly owned subsidiary, the University of Phoenix,

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[60] *Id.*, 2009 WL 388048 at *1.
[61] *See id.*, 2009 WL 388048 at *4.
[62] *Id.* at *5.
[63] *Id.* at *11.
[64] *Id.* at *11-*12.
[65] *In re Apollo Group Inc. Sec. Litig.*, 2008 WL 3072731 (D. Ariz. Aug. 4, 2008), Fed. Sec. L. Rep. ¶ 94,798.

had violated DOE regulations.[66] On September 14 and 15, 2004, the contents of the DOE report were widely disseminated—including in articles in *The Wall Street Journal*, *The Arizona Republic,* and *The Chicago Tribune*—but the market did not react in any significant way. Several days later, an analyst issued two reports—one on Apollo and one on the industry—and downgraded Apollo's stock for various reasons, including its prediction of future regulatory problems in light of the previously disclosed program review report, and Apollo's stock declined significantly.[67]

At trial, plaintiffs' loss causation theory depended entirely on the jury finding that the analyst reports were corrective disclosures. Indeed, the court instructed the jury that loss causation could only be found if the analyst reports were "corrective disclosures."[68] The jury found for plaintiffs and awarded damages of $5.55 per share, which plaintiffs' expert estimated would yield damages of more than $275 million.

Although the court had previously denied our motion for summary judgment making the same loss causation argument, we moved for judgment as a matter of law under Federal Rule of Civil Procedure 50(b). Under Rule 50(b), the court may direct a judgment contrary to the jury's verdict if it finds that the jury did not have a legally sufficient evidentiary basis for its decision on a dispositive issue.[69] The dispositive question presented in our Rule 50(b) motion was whether the evidence at trial was sufficient to support the jury's finding that the analyst reports were corrective disclosures. The court found that there was not and granted judgment in favor of Apollo.

In its ruling, the court explained that loss causation could be established by showing that a corrective disclosure caused a stock price to decline.[70] A corrective disclosure "is a disclosure that reveals the fraud, or at least some aspect of the fraud, to the market." By contrast, a "disclosure that does not reveal anything new to the market is, by definition, not corrective."[71] The

[66] *Id.*, 2008 WL 3072731 at *1.
[67] *Id.*
[68] *Id.*
[69] *See* Fed. R. Civ. P. 50(b); *see also* Fed. R. Civ. P. 50(a).
[70] *Id.* at *2.
[71] *Id.*

court stated that it had not granted our motion for summary judgment because it could have done so only if it concluded that a market professional's analysis of facts that had previously been disclosed to the public could *never* be a corrective disclosure, which the court was unwilling to do.[72] It conceded, however, that "the situations in which the pertinent facts are obfuscated in such a way, or are of such complexity, as to require someone to connect the dots for a bewildered market represent a very rare type of securities fraud case, and would not be the rule."[73]

After the presentation of evidence at trial, the court concluded that *Apollo* was not such a "very rare type" of case. It found that the analyst reports did not provide any new information. It also rejected plaintiffs' argument that the analyst reports were the first to predict future regulatory problems because of the previously disclosed contents of the DOE report because the *Chicago Tribune* had previously published an article titled "School Fine May Foretell Crackdown," to which the market did not discernibly react. The court concluded that the analyst reports did not constitute corrective disclosures, and plaintiffs had not met their burden of establishing loss causation.[74]

Most Important Recent Securities Fraud Cases

There has been a plethora of important decisions from the appellate courts in the past year regarding secondary liability, the fraud-on-the-market presumption of reliance, pleading scienter and loss causation. The following discusses the most important recent cases.

Liability of Secondary Actors: *Stoneridge* (Supreme Court)

In *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 128 S. Ct. 761 (2008),[75] the Court reaffirmed its decision in *Central Bank of Denver* that liability under Section 10(b) does not extend to aiders and abettors, and held that, to be actionable, the conduct of a secondary actor must itself satisfy each of the elements or preconditions for liability under Section

[72] *Id.*
[73] *Id.* at *3.
[74] *Id.* at *3-*4.
[75] *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 128 S. Ct. 761 (2008).

10(b) or Rule 10b-5.[76] The petitioner argued, on behalf of a class of investors in Charter Communications Inc., that the respondents—certain equipment vendors of Charter—had "agreed to arrangements that allowed [Charter] to mislead its auditor and issue a misleading financial statement," even though respondents themselves "had no role in preparing or disseminating Charter's financial statements."[77] The Supreme Court affirmed the Eighth Circuit's judgment upholding the dismissal of petitioner's claim against respondents because the petitioner failed to adequately allege reliance on the respondents' deceptive acts.[78]

The Court concluded that "the implied right of action does not reach the customer/supplier companies because the investors did not rely upon their statements or representations."[79] In doing so, the Court noted that there need not "be a specific oral or written statement before there could be liability under §10(b) or Rule 10b-5," given that "[c]onduct itself can be deceptive," but insisted on an adequate showing of reliance to "ensur[e] that . . . the 'requisite causal connection between a defendant's misrepresentation and a plaintiff's injury exists as a predicate for liability.'"[80] The Court also underscored the adverse "practical consequences of" petitioner's intended expansion of Section 10(b)'s private cause of action, including: (i) the increased risk that "innocent companies" would have to pay "extort[ionate] settlements" to avoid the cost, uncertainty, and disruption that even "weak claims" under Section 10(b) cause; (ii) the deterrent effect on "[o]verseas firms with no other exposure to our securities laws"; and (iii) the resultant "shift [of] securities offerings away from domestic capital markets."[81] Finally, the Court emphasized that "[s]econdary actors are subject to criminal penalties . . . and civil enforcement by the SEC," that "[t]he enforcement power is not toothless," and that "some state securities laws permit state authorities to seek fines and restitution from aiders and abettors."[82] Accordingly, the Court found that investors would not be left without an effective remedy to redress any

[76] *Id.* at 769.
[77] *Id.* at 766.
[78] *Id.* at 774.
[79] *Id.* at 766.
[80] *Id.* at 769.
[81] *Id.* at 772.
[82] *Id.* at 773.

perceived wrongful conduct by secondary actors, such as the equipment suppliers to Charter.

Fraud-On-The-Market Presumption: *Teamsters Local 445* (2nd Circuit)

In *Teamsters Local 445 v. Bombardier Inc.,* 546 F.3d 196 (2d Cir. 2008), the Second Circuit affirmed the district court's denial of class certification on the ground that plaintiffs had failed to demonstrate market efficiency for the debt securities at issue, which were backed by mobile home loans and leases, and therefore could not rely on the fraud-on-the-market presumption. The Second Circuit first clarified that plaintiffs bear the burden to show the facts necessary for class certification by a "preponderance of the evidence" rather than merely "some showing." It then addressed whether plaintiffs had established the fraud-on-the-market presumption.

The Second Circuit had not developed a standard for determining whether the market for a particular security is entitled to the fraud-on-the-market presumption. However, other courts addressing this issue had relied upon factors first articulated by a New Jersey federal court in *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989). These factors (commonly referred to as the "*Cammer* factors") include: (1) average weekly trading volume expressed as a percentage of total outstanding shares; (2) the number of securities analysts following and reporting on the security; (3) the extent to which market makers and arbitrageurs trade in the security; (4) the company's eligibility to file SEC registration Form S-3; and (5) the existence of a cause-and-effect relationship between unexpected corporate news and changes in the price of the security.[83]

The court began its analysis by acknowledging that it had not yet adopted a test for determining the market efficiency of stocks or bonds, and expressly declined to adopt one here. Nevertheless, it proceeded to address the efficiency of the market for the certificates within the *Cammer* rubric, noting that "[t]he *Cammer* factors have been routinely applied by district courts" and that the plaintiffs "d[id] not contest the district court's consideration of

[83] *Teamsters Local 445*, 546 F.3d at 200.

the Cammer factors." This was the first time the Second Circuit has applied the *Cammer* factors to determine market efficiency.

The court focused on the three *Cammer* factors utilized by the district court in denying plaintiffs' motion for class certification. First, the court found that although numerous analysts were following Bombardier, the activities of those analysts were irrelevant because the certificates were issued by Bombardier Capital Mortgage Securitization Corporation (BCM), a subsidiary two steps removed from Bombardier, and not Bombardier. Because the value of the certificates was only incidentally related to Bombardier's performance, the analyst coverage of Bombardier did not significantly contribute to the efficiency of the certificate market.[84] Second, the plaintiffs failed to identify a firm that regularly published bids and quotes for the certificates or that would furnish bids and quotes on request and effect transactions for certificates. The court concluded that the absence of such a "market maker" supported a finding of inefficiency.[85]

Third, although plaintiffs proffered an event study purporting to demonstrate a relationship between news about Bombardier and the price of the certificates, the court did not credit this study because measuring price reactions to news solely concerning the financial health of Bombardier, and not BCM, was irrelevant. In fact, the certificate transaction prices reacted weakly to unexpected downgrades of the certificates themselves in 2002 and 2003.[86] Based on its analysis of these *Cammer* factors, the Second Circuit held that the certificate market was inefficient, thereby preventing plaintiffs from relying on the fraud-on-the-market presumption and from certifying a class.[87]

Fraud-On-The-Market Presumption: *Salomon Analyst Metromedia Litigation* (2nd Circuit)

In *In Re Salomon Analyst Metromedia Litigation*, 544 F.3d 474 (2d Cir. 2008),[88] the Second Circuit held that plaintiffs alleging securities fraud against

[84] *Id.* at 205.
[85] *Id.* at 206-207.
[86] *Id.* at 207-208.
[87] *Id.* at 210.
[88] *In Re Salomon Analyst Metromedia Litigation,* 544 F.3d 474 (2d Cir. 2008).

research analysts do not need to make a heightened evidentiary showing to benefit from the fraud-on-the-market presumption of *Basic Inc. v. Levinson*. Defendants argued that the *Basic* presumption should be limited to suits involving misrepresentations made by issuers because misrepresentations by third parties, such as research analysts, are less likely to materially affect market prices. The court rejected that argument, reasoning that the premise of *Basic* is that, in an efficient market, share prices reflect "all publicly available information, and, hence, any material misrepresentations."[89] "It thus does not matter, for purposes of establishing entitlement to the presumption, whether the misinformation was transmitted by an issuer, an analyst, or anyone else."[90] The court vacated the grant of class certification, however, "because the district court erred in not permitting defendants to attempt to rebut the presumption prior to class certification."[91]

Scienter: *Mizzaro v. Home Depot* (11th Circuit)

In *Mizzaro v. Home Depot Inc.*, 544 F.3d 1230 (11th Cir. 2008),[92] the Eleventh Circuit held that the complaint failed to satisfy the standard for pleading scienter under the PSLRA and *Tellabs*. The plaintiff alleged that Home Depot had obtained excessive rebates from its vendors and violated Section 10(b) by not informing investors that the financial results it reported for fiscal years 2001 to 2004 were inflated by these excessive rebates. The Eleventh Circuit agreed that the allegations in the complaint established that Home Depot stores processed improper rebates. But the court noted that "simply alleging that a widespread fraud may have occurred is not enough" because the allegations in the complaint also must create a strong inference, one that is cogent and compelling, that the individual defendants knew about the alleged fraud (or were severely reckless in not knowing about it) when they made the purportedly false or misleading statements.[93]

The court stated that the complaint "relies exclusively on the widespread nature of the fraud, and the purported amount of the fraud, to draw a strong inference that the individual defendants (all high-ranking officials)

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[89] *Id.* at 481 (emphasis in original) (citations omitted).
[90] *Id.*
[91] *Id.* at 485-86.
[92] *Mizzaro v. Home Depot Inc.*, 544 F.3d 1230 (11th Cir. 2008).
[93] *Id.* at 1247.

acted with the requisite scienter."[94] But there was no evidence actually connecting the individual defendants to the alleged fraud, and the confidential witnesses did not even claim to have met any of the individual defendants. The court was skeptical of "allegations that hinge entirely on a theory that senior management 'must have known' everything that was happening in a company as large as Home Depot, which operates over 2000 stores."[95] In short, the complaint "must at least allege some facts showing how knowledge of the fraud would or should have percolated up to senior management."[96]

The court found that the complaint failed to make this showing and instead relied entirely on speculation. The court concluded that the "complaint contains no allegations directly linking the named defendants to the [rebate] fraud, and the allegations about the geographic scope, duration, and amount of the alleged fraud are insufficient to create a 'strong inference' (meaning a 'cogent and compelling' one) that the individual defendants orchestrated the fraud, knew about it, or were severely reckless in not knowing about it."[97]

<u>Misrepresentations and Scienter: *Ley v. Visteon* (6th Circuit)</u>

In *Ley v. Visteon* 543 F.3d 801 (6th Cir. 2008)[98] the Sixth Circuit upheld the dismissal of an action under Section 10(b) for failure to plead a misrepresentation or a strong inference of scienter. Plaintiffs argued that defendants failed to disclose adequately that Visteon might have difficulty shedding unprofitable business lines and that it was overly dependent upon one customer. To the contrary, the court found that the relevant prospectus and subsequent disclosures were "rife with such information.""[99]

Additionally, plaintiffs argued that Visteon had a duty in its public disclosures to compare its costs with those of its competitors. The court held that "[t]he federal securities laws do not ordain that the issuer of a security compare itself in myriad ways to its competitors, whether favorably or unfavorably, for at least three reasons. First, such a requirement would

[94] *Id.*
[95] *Id.* at 1250-51.
[96] *Id.* at 1251.
[97] *Id.* at 1254.
[98] *Ley v. Visteon,* 543 F.3d 801 (6th Cir. 2008).
[99] *Id.* at 807.

impose an onerous if not insurmountable obstacle on issuers of securities to ensure they obtain accurate information on all aspects of their competitors, which a reasonable investor might find material. Second, were we to announce such a requirement, the likely result would be to inundate the investor with what the Supreme Court disparaged as 'an avalanche of trivial information.' Third—and of greatest consequence—it is precisely and uniquely the function of the prudent investor, not the issuer of securities, to make such comparisons among investments."[100]

As for pleading scienter, the court found that plaintiffs' anonymous confidential witness allegations, while potentially relevant to determining scienter, were too vague and conclusory to be given much weight.[101] Additionally, plaintiffs failed to plead facts demonstrating that the individual defendants' signing of Sarbanes-Oxley certifications was severely reckless.[102] The court also found that the nature and extent of the accounting improprieties were not sufficient to support a strong inference of scienter.[103] The court concluded that the allegations, taken together and viewed collectively, failed to adequately plead a strong inference of scienter on the part of Visteon and the individual defendants, as well as Visteon's outside auditor.

Scienter: *In re Ceridian* (8th Circuit)

In *In re Ceridian Corp. Securities Litigation*, 542 F.3d 240 (8th Cir. 2008)[104] the Eighth Circuit affirmed dismissal of the complaint for failure to satisfy the PSLRA's requirement of pleading with particularity facts giving rise to a strong inference of scienter. The court agreed with the district court's characterization of the class action as "a sprawling jumble of a securities fraud action . . . based on dozens, if not hundreds, of accounting errors—errors of many different types committed by many different employees over many different years."[105] The court disagreed with plaintiffs' argument that "the sheer number of violations, and the magnitude of the restatements,

[100] *Id.* at 808.
[101] *Id.* at 811.
[102] *Id.* at 812.
[103] *Id.*
[104] *In re Ceridian Corp. Sec. Litig.*, 542 F.3d 240 (8th Cir. 2008).
[105] *Id.* at 245.

give rise to an inference that defendants were at least severely reckless."[106] It also held that the CFO's and CEO's sale of 200,000 shares of stock, and receipt of substantial year-end bonuses based primarily on earnings and revenue growth, were insufficient to give rise to a strong inference of scienter.[107] The court found that vague allegations of confidential witnesses and two whistleblowers were also insufficient, particularly as they did not implicate the relevant time period.[108] Similarly, allegations of accounting errors that "were discovered months and years later" were insufficient to create the required strong inference that officers' certifications were knowingly false when made.[109]

Scienter: *South Ferry v. Killinger* (9th Circuit)

In *South Ferry LP No. 2 v. Killinger*, 542 F.3d 776 (9th Cir. 2008),[110] the Ninth Circuit relaxed the standard for pleading scienter with respect to a company's "core operations." The Ninth Circuit noted that in light of *Tellabs* "perhaps" certain of its earlier leading decisions (*Silicon Graphics*, *Vantive*, and *Read-Rite*) "are too demanding and focused too narrowly in dismissing vague, ambiguous, or general allegations outright."[111] While it did not go so far as to conclude that *Tellabs* overruled those earlier decisions, the court held that motions to dismiss under the PSLRA require courts "to consider the totality of circumstances, rather than to develop separately rules of thumb for each type of scienter allegation."[112] Thus, it concluded that "[v]ague or ambiguous allegations are now properly considered as part of a holistic review when considering whether the complaint raises a strong inference of scienter."[113]

On the specific question of whether pleading that alleged misstatements concerned "core operations" can give rise to a strong inference of scienter, the court found that such allegations "may be relevant and help to satisfy

[106] *Id.* at 246.
[107] *Id.* at 246-47.
[108] *Id.* at 247-48.
[109] *Id.* at 248.
[110] *South Ferry LP No. 2 v. Killinger*, 542 F.3d 776 (9th Cir. 2008).
[111] *Id.* at 784.
[112] *Id.*
[113] *Id.*

the PSLRA scienter requirement in three circumstances."[114] First, they may be "used in any form along with other allegations" that combine to create a strong inference of scienter.[115] Second, "such allegations may independently satisfy the PSLRA where they are particular and suggest that defendants had actual access to the disputed information."[116] Third, in "rare circumstances," the "core operations" allegations alone may satisfy the PSLRA "where the nature of the relevant fact is of such prominence that it would be 'absurd' to suggest that management was without knowledge of the matter."[117] Because the district court had ruled before *Tellabs* was decided, the Ninth Circuit remanded the case for further consideration in light of the new standard.[118]

<u>Scienter: *Zucco Partners* (9th Circuit)</u>

In *Zucco Partners LLC v. Digimarc Corporation*,[119] the Ninth Circuit issued an opinion in February 2009 regarding the sufficiency of scienter allegations in a Section 10(b) case that, according to the court, more fully explains the application of *Tellabs* to the Ninth Circuit's analysis of scienter developed in pre-*Tellabs* decisions. The Ninth Circuit held that *Tellabs* "does not materially alter the particularity requirements for scienter claims established in our previous decisions, but instead only adds an additional 'holistic' component to those requirements."[120] The Ninth Circuit stated that *Tellabs* merely requires that the court, in addition to considering each of the scienter allegations individually, must also consider whether combined or as a whole they create a strong inference of scienter (also taking into account plausible competing inferences).

The court explained that "[w]e read *Tellabs* to mean that our prior, segmented approach is not sufficient to dismiss an allegation of scienter. Although we have continued to employ the old standards in determining whether, a plaintiff's allegations of scienter are as cogent or as compelling as

[114] *Id.* at 785.
[115] *Id.* at 785-86.
[116] *Id.* at 786.
[117] *Id.*
[118] *Id.*
[119] *Zucco Partners LLC v. Digimarc Corporation*, --- F.3d ---, 2009 WL 311070 (9th Cir. Feb. 10, 2009).
[120] *Id.*, 2009 WL 311070 at *1.

an opposing innocent inference, we must also view the allegations as a whole."[121] The Ninth Circuit stated that following *Tellabs* it would therefore follow a "dual inquiry" in determining whether plaintiffs have pleaded facts giving rise to a strong inference of scienter. "First, we will determine whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter[.]"[122] Second, "if no individual allegations are sufficient, we will conduct a 'holistic' review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness."[123]

The decision includes analyses of several alleged grounds for scienter: (1) confidential witness allegations; (2) a restatement; (3) resignations of corporate officers; (4) Sarbanes-Oxley certifications; (5) executive compensation; (6) executive stock sales; and (7) the company's private placement during the class period.[124] The court affirmed dismissal with prejudice, holding that the allegations both separately and combined did not give rise to a strong inference of scienter, particularly in light of the compelling alternative inference that the company was simply struggling to integrate a large, new division into its business.[125]

<u>Loss Causation, Scienter and Falsity: *Metzler v. Corinthian Colleges* (9th Circuit)</u>

In *Metzler Investment GMBH v. Corinthian Colleges Inc.,* 540 F.3d 1049 (9th Cir. 2008)[126] the Ninth Circuit affirmed the dismissal of a Section 10(b) and Rule 10b-5 claim for failure to plead adequately loss causation, scienter, and false statements. Corinthian is one of the nation's largest operators of private, for-profit vocational colleges. The complaint alleged that Corinthian's colleges were pervaded by fraudulent practices designed to maximize the amount of federal Title IV funding, a major source of Corinthian's revenue, and that Corinthian violated Generally Accepted Accounting Principles (GAAP) by improperly recognizing revenue. Plaintiff contended that the

[121] *Id.* at *6 (citations omitted).
[122] *Id.*
[123] *Id.*
[124] *See id.* at *7-*20.
[125] *See id.* at *21.
[126] *Metzler Investment GMBH v. Corinthian Colleges Inc.*, 540 F.3d 1049 (9th Cir. 2008).

fraudulent scheme involved, among other things, the falsification of financial aid applications and student grades, the manipulation of student enrollment and job placement data, and the concealment of Department of Education and California attorney general investigations. The complaint also alleged that Corinthian violated GAAP by improperly recognizing an entire month's worth of tuition revenue for a student's first month of attendance regardless of when the student actually started.[127]

The Ninth Circuit held that the complaint failed to plead loss causation because it did not allege that the purported corrective disclosures "disclosed—or even suggested—to the market that Corinthian was manipulating student enrollment figures company-wide in order to procure excess federal funding, which is the fraudulent activity that Metzler contends forced down the stock and caused its losses."[128] Although *Dura* does not require an admission or finding of fraud before loss causation can be properly pleaded, according to the court, "that does not allow a plaintiff to plead loss causation through 'euphemism' and thereby avoid alleging the necessary connection between defendant's fraud and the actual loss."[129] The court further stated, "[s]o long as there is a drop in a stock's price, a plaintiff will always be able to contend that the market 'understood' a defendant's statement precipitating a loss as a coded message revealing the fraud. Enabling a plaintiff to proceed on such a theory would effectively resurrect what *Dura* discredited—that loss causation is established through an allegation that a stock was purchased at an inflated price …. Loss causation requires more."[130]

The court further held that plaintiff had failed to plead scienter adequately under the *Tellabs* standard. The court explained that, while "'suspicious stock sales by corporate insiders may constitute circumstantial evidence of scienter,' such sales only give rise to an inference of scienter when they are "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information"—factors not established in the case.[131] The court also reasoned that

[127] *Id.* at 1055-58.
[128] *Id.* at 1063.
[129] *Id.* at 1064.
[130] *Id.*
[131] *Id.* at 1066-67.

"corporate management's general awareness of the day-to-day workings of the company's business does not establish scienter—at least absent some additional allegation of specific information conveyed to management and related to the fraud."[132] The court further concluded that the allegations concerning Corinthian's revenue recognition practices failed to raise a strong inference of scienter because the complaint did not sufficiently allege that management knowingly and recklessly engaged in an improper accounting practice.[133] Finally, the court held that plaintiff failed to meet the PSLRA's "exacting requirements" for pleading falsity, noting that "[a] litany of alleged false statements, unaccompanied by the pleading of specific facts indicating why those statements were false, does not meet this standard."[134]

Scienter: *Teamsters Local 445 v. Dynex Capital* (2nd Circuit)

In *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190 (2nd Cir. 2008)[135] the Second Circuit considered whether a securities fraud plaintiff could plead the scienter of a corporation without specifically identifying the culpable corporate officer or director whose individual scienter could be imputed to the corporation. The defendants were a financial services company and its subsidiary that issued two sets of securities secured by thousands of mortgage loans the company had made to people seeking to purchase manufactured homes. Not long after issuance of the securities, the value of its collateral dropped sharply due an increase in defaults on the underlying loans and a decrease in the profits of post-foreclosure sales.

Although it ruled that plaintiffs had failed to adequately plead scienter in this case, the Second Circuit left open the possibility that corporate scienter could be pleaded without identifying the culpable officer in the complaint. The court stated that "Congress has imposed strict requirements on securities fraud pleading, but we do not believe they have imposed the rule urged by defendants, that in no case can corporate scienter be pleaded in the absence of successfully pleading scienter to an expressly named

[132] *Id.* at 1068.
[133] *Id.* at 1068-69.
[134] *Id.* at 1070.
[135] *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190 (2nd Cir. 2008).

officer."[136] In this case, however, the plaintiff made only general allegations that Dynex agents had information to indicate that its public statements were not accurate, and they did not specifically identify those reports or information as required.[137]

The court applied the *Tellabs* standard, finding that the alleged inferences of scienter were not significantly more compelling than the competing inferences, including an inference that the statements were not misleading when made or that they were "the result of merely careless mistakes at the management level based on false information fed it from below" as opposed to recklessness that arises to the level of culpable scienter.[138]

Scienter: *Public Employees Retirement Ass'n v. Deloitte & Touche* (4th Circuit)

In *Public Employees Retirement Ass'n of Colorado v. Deloitte & Touche*, 551 F.3d 305 (4th Cir. 2009), the Fourth Circuit held that plaintiffs failed to plead a strong inference of scienter against an issuer's accountants. The lawsuit arose out of alleged improper accounting by Royal Ahold and its subsidiary U.S. Foodservice Inc. Plaintiffs alleged that Ahold improperly recognized all of the revenue of joint ventures with supermarket operators in Europe and the United States, when it should only have recognized the revenue proportionately to its stake in the ventures because it did not have a controlling interest.[139] Deloitte had advised Ahold that it could consolidate the revenues of the joint ventures only if it had a controlling interest in them, and Ahold represented to Deloitte that it indeed had the control requisite for consolidation.

Deloitte subsequently became concerned that Ahold did not have a controlling interest, and it requested further proof. Ahold then provided Deloitte with letters signed by Ahold's joint venture partners indicating that Ahold controlled the joint ventures. Ahold then entered into secret side agreements with the joint venture partners, stating that they did not agree with the statements in the letters provided to Deloitte.[140] Plaintiffs also

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[136] *Id.* at 196.
[137] *Id.*
[138] *Id.* at 197.
[139] *Id.* at 307.
[140] *Id.* at 308-309.

alleged that U.S. Foodservice (USF) falsely reported its income from vendor rebates. Two USF executives and several vendor representatives pleaded guilty to criminal fraud charges and admitted that they had lied to and deceived Deloitte regarding the vendor rebates, including signing false audit confirmation letters that overstated the vendor rebate amounts.[141]

In evaluating plaintiffs' scienter allegations, the Fourth Circuit stated that under *Tellabs* "the question is whether the allegations in the complaint viewed in their totality and in light of all the other evidence in the record, allow us to draw a strong inference, at least as compelling as any opposing inference, that the Deloitte defendants either knowingly or recklessly defrauded investors by issuing false audit opinions[.]"[142] The court found the allegations regarding the consolidation of joint venture revenues insufficient to create a strong inference against Deloitte. Rather, "[t]he most plausible inference that one can draw from the fact that Ahold concealed the side letters from its accountants is that the accountants were uninvolved in the fraud."[143]

Plaintiffs argued that Deloitte was complicit in the fraud because it could have done more to investigate Ahold's claims of control. But the court stated that "to establish a strong inference of scienter, plaintiffs must do more than merely demonstrate that defendants should or could have done more. They must demonstrate that the [Deloitte entities] were either knowingly complicit in the fraud, or so reckless in their duties as to be oblivious to malfeasance that was readily apparent."[144] The court concluded that "[t]he inference we find most compelling based on the evidence in the record is not that the defendants were knowingly complicit or reckless, but that they were deceived by their client's repeated lies and artifices."[145] The court found the same with respect to the vendor rebates, as to which Ahold had also deceived Deloitte.[146] It concluded "[t]hat inference is significantly more plausible than the competing inference that defendants somehow knew that Ahold and USF were defrauding their investors."[147]

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[141] *Id.* at 310.
[142] *Id.* at 313.
[143] *Id.* at 314.
[144] *Id.*
[145] *Id.*
[146] *Id.* at 315-16.
[147] *Id.* at 316.

Loss Causation: In re Gilead Sciences (9th Circuit)

In *In re Gilead Sciences Sec. Litig.*, 536 F.3d 1049 (9th Cir. 2008),[148] the Ninth Circuit held that a complaint adequately pleaded loss causation under *Dura*, and reversed the district court's dismissal. Gilead Sciences is a biopharmaceutical company that specializes in developing and marketing treatments for life-threatening diseases. Plaintiffs alleged that the defendants misled the investing public by representing that demand for Gilead's most popular product—Viread, an antiretroviral agent used to treat HIV—was strong, without disclosing that unlawful marketing was the cause of that strength. Viread accounted for almost two-thirds of Gilead's total revenues, and the complaint alleged that Gilead and some of its top officers violated Sections 10(b) and 20(a) of the 1934 Act by not disclosing that the company was aggressively promoting Viread for "off-label" uses, i.e., for uses that had not been approved by the FDA. The complaint outlined an alleged scheme to promote off-label uses and further alleged that ultimately "75% to 95% of Viread sales resulted from off-label marketing efforts." The FDA sent Gilead a letter in March 2002, accusing the company of off-label marketing, and in August 2003 the FDA made public a July 2003 "warning letter," but the investing public allegedly did not appreciate the letter's significance, and the stock price did not drop until October 28, 2003, when the company issued a press release reporting disappointing financial results due to a decline in Viread sales.[149]

The district court dismissed the action with prejudice on the ground that plaintiffs failed to adequately plead loss causation under *Dura* because the complaint failed to connect the following chain of events: (1) that the alleged failure to disclose the off-label marketing scheme caused a material increase in sales; (2) that practitioners materially decreased their demand for Viread because of the publication of the FDA warning letter; and (3) that the alleged decrease in sales due to the FDA letter proximately caused Gilead's stock to decrease three months later.[150]

The Ninth Circuit reversed, holding that "[a] limited temporal gap between the time a misrepresentation is publicly revealed and the subsequent decline

[148] *In re Gilead Sciences Sec. Litig.*, 536 F.3d 1049 (9th Cir. 2008).
[149] *Id.* at 1050-54.
[150] *Id.* at 1054.

in stock value does not render a plaintiff's theory of loss causation *per se* implausible."[151] The court stated that the allegations in the complaint convinced it that the October drop in stock price was plausibly caused by the warning letter. "Importantly, the drop occurred immediately after Gilead disclosed less-than-expected revenues resulting from the reduction in wholesalers' Viread inventories, which analysts ascribed to lower end-user demand. That lower end-user demand, in turn, is expressly alleged to have been caused by the Warning Letter." The court concluded that "[i]n this light, the market did react immediately to the corrective disclosure—the October 28 press release."[152]

Strategies and Methods for Handling New Securities Fraud Claims

If a client becomes the target of a securities class action lawsuit, we recommend taking the following steps at the beginning of the case to best position the company and to minimize disruption caused by the lawsuit.

1. Contact Plaintiffs' Counsel Regarding Service and Time to Respond

Through the company's counsel, you should contact plaintiffs' attorneys to discuss service of the summons and complaint. The company and individual defendants can gain valuable additional time to respond by agreeing to waive personal service. Doing so also prevents process servers from interfering with the company's officers and directors either at work or at home. Plaintiffs usually will agree because it avoids costly and time-consuming efforts to serve individuals.

2. Distribute a Document Retention Memorandum and Preserve Electronic Data

You should distribute a document retention memorandum and take other steps to preserve potentially relevant information. Defendants in securities class action litigation are legally obligated to preserve certain potentially relevant information, including information stored electronically on a company's computer system. Moreover, the most damaging document can often be the one that no longer exists. Speculation over its contents and excuses for its disappearance can be

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[151] *Id.* at 1058.
[152] *Id.*

devastating. Particular care should be taken to preserve e-mail and data located on computer storage devices, as this type of information is taking on increasing significance in all litigation, particularly securities class action litigation.

3. Notify the Company's Directors and Officers Liability Insurance Carrier

It is important to promptly notify the company's primary, and any excess, directors and officers liability insurance carriers. D&O policies usually require prompt notice of litigation against the insureds. Furthermore, they may provide for reimbursement of defense costs. If the policy does not furnish coverage for the company, it may seek to negotiate an allocation of defense costs between the company and the insureds.

4. Consider Joint or Separate Representation

Analyze the issue of joint versus separate representation for individual defendants. Where possible, the simplest approach is for the company and its officers and directors to be represented by a single law firm. If plaintiffs' claims are based on alleged misrepresentations or omissions in the company's public disclosures, most likely there will not be a need for separate counsel. If the company believes from its investigation of the claims that certain executives or employees were responsible for wrongdoing, it may be necessary for them to have separate counsel because the company's interests and the individuals' interests may be divergent. This particularly becomes an issue where SEC or DOJ investigations of the conduct exist or are likely, as those who are believed to have engaged in particular wrongdoing may individually face civil or criminal exposure. Furthermore, the company likely will want to cooperate with the SEC or DOJ, while individuals who engaged in wrongful or questionable conduct may find it necessary to invoke their Fifth Amendment rights. If separate counsel is retained, the company will need to consider whether to enter into a written or oral joint defense agreement with the other counsel.

5. Contact Outside Accountants

Accounting issues are frequently at the center of securities fraud cases. Although outside accountants are less likely to be named as defendants under the PSLRA, we recommend that the company's counsel contact the outside accountants' counsel as soon as possible to establish a line of communication. Plaintiffs' counsel and regulatory authorities, such as the SEC, may subpoena outside accountants in an effort to build a case against the company. Absent unusual circumstances, we have found that a company is better served by embracing rather than attempting to blame the outside accountants.

6. Gather Information Regarding Stock Sales by Insiders

The company should gather information, such as SEC Form 4s, regarding insiders' sales of the company's stock. Under the PSLRA, plaintiffs must plead the facts that support an inference that defendants acted with fraudulent intent. Very often, plaintiffs point to recent sales by company insiders, but they must demonstrate that any such sales were "unusual." Defendants may rebut such a showing by demonstrating that insider sales were consistent with sales in prior years or that they represent a relatively small percentage of the insider's total holdings.

7. Review Key Documents and Interview Key Personnel

Counsel should be retained promptly to investigate the plaintiffs' allegations. An effective investigation will require collecting and reviewing key documents, particularly the company's SEC filings, press releases, analysts' reports, transcripts of meetings and conference calls with analysts, and media reports, such as newspaper and magazine articles and tapes of any television or radio reports. Interviewing key personnel early also will facilitate formulation of a defense strategy.

8. Prepare Response to Complaint

Unless additional time is obtained by agreement or by waiving personal service, defendants must respond to a lawsuit within as little as twenty days of service. Plaintiffs will usually agree that a response to the complaint can be postponed until a lead plaintiff is appointed and an amended consolidated complaint is filed. In most cases, the company and individual defendants will want to focus on preparing a motion to dismiss, which, at least in federal court, will serve to stay discovery. While such motions may not dispose of the litigation entirely, they may serve to obtain dismissal of certain individual defendants or to eliminate some of the claims. Moreover, the discovery stay under the PSLRA may remain in effect for several months, providing an opportunity to more fully investigate plaintiffs' allegations, to refine the defense strategy, and to consider settlement options.

9. Consider Settlement Strategy

Litigation strategy will often be guided in part by settlement considerations. Because of high litigation costs, securities class action cases infrequently reach trial. Rather, they are usually resolved through dispositive motions or settlement. Engaging in early settlement negotiations may significantly reduce the amount of the settlement, as well as the company's litigation costs.

10. Retain a Damages and Loss Causation Expert

In evaluating defendants' settlement position, it is useful to understand the potential range of damages and potential loss causation arguments, which can eliminate or reduce estimated damages. We work with experts who can promptly prepare a damages analysis and can carefully analyze loss causation issues. Isolating the effect of a corrective disclosure on a stock price usually requires expert testimony. The tool generally used by experts is an "event study." The event study enables the expert to show the decline in the stock price attributable to market and industry factors unrelated to the corrective disclosure. Once this is accomplished, if a statistically significant price decline remains, the expert may conclude that the corrective disclosure, and thus the alleged fraud, caused that remaining decline. If the alleged corrective disclosure was made at the same time as the disclosure of other bad news, the expert will be able to determine whether it is possible to isolate the impact of the corrective disclosure.

11. Develop and Follow Your Media Strategy

Finally, the company should develop and follow a strategy for communicating with the media about the lawsuit. A single contact person should be appointed to respond to all media inquiries. Generally, statements should be limited to acknowledging that a lawsuit has been filed and stating that the company's attorneys are investigating the allegations. Any other comments should be made with care. For example, statements that the litigation is meritless have on occasion resulted in a second round of shareholder litigation when the company has ultimately settled the claims.

Conclusion

The subprime and credit crisis has brought on a wave of securities class action litigation directed primarily against financial institutions. Those cases are in their early stages, and their outcomes will undoubtedly be influenced by the plethora of recent appellate decisions on the issues of loss causation, scienter, and application of the fraud-on-the-market theory. It remains to be seen whether the wave of securities litigation will spread to companies outside the financial sector, similar to how the financial crisis grew into an economy-wide recession. But when companies have bad news and their stock price drops, securities litigation often follows.

It is also unclear whether and to what extent the financial crisis will result in reform affecting private securities litigation. Rather than reining in private securities class action litigation, as Congress attempted in the PSLRA and SLUSA, in light of the current financial crisis, reform proposals may well have as their goal increasing the perceived deterrent and remedial effects of private securities litigation.

The crisis, of course, has spurred calls for regulatory reform, including merger of the SEC and CFTC, making the Federal Reserve a "super regulator" with oversight of market stability throughout the financial sector, and requiring registration and oversight of hedge funds. Congress will be busy enough with regulatory reform proposals that it may not turn its attention to reforming private securities litigation in the near term. With or without new legislation, the courts will continue to develop and apply a complex set of legal standards to the issues presented by the current wave of subprime and credit crisis-related litigation.

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