Morgan Lewis

securities lawflash

alert

www.morganlewis.com

2011 Year in Review: Selected Federal Securities Litigation Developments

In 2011, the Supreme Court and the federal circuit courts issued a number of important decisions concerning securities fraud class actions. These decisions address pleading standards, statutes of limitations defenses, class certification, and a number of other critical topics.

February 13, 2012

Morgan Lewis is pleased to present its fourth annual review of selected decisions from the U.S. Courts of Appeals addressing private actions under the federal securities laws.[1]

This LawFlash highlights several important cases and interesting trends in 2011. The full 2011 Year in Review, which includes summaries of approximately 50 cases, is available at http://www.morganlewis.com/pubs/LIT_2011YrReviewSelectedFederalSecuritiesLitDevelopments_13feb12.pdf.

The U.S. Supreme Court

The Supreme Court issued three important decisions, continuing its recent activity in the securities field. First, in *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. —, 131 S. Ct. 2179, 180 L. Ed. 2d 24 (June 6, 2011), the Supreme Court rejected the Fifth Circuit's requirement that loss causation be established at the class certification stage in order to invoke the fraud-on-the-market theory of reliance. According to the opinion authored by Chief Justice Roberts, "[l]oss causation has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory." 131 S. Ct. at 2186.

Second, in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. —, 131 S. Ct. 2296, 180 L. Ed. 2d 166 (June 13, 2011), the Supreme Court built on its decisions in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119 (1994), and *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S. Ct. 761, 169 L. Ed. 2d 627 (Jan. 21, 2008), holding that a mutual fund investment adviser and parent company could not be held civilly liable under Rule 10b-5 for alleged misstatements in a

1. The review was prepared by Morgan Lewis partners Brian Herman and John Vassos, of counsel Karen Pieslak Pohlmann, and associates Laura Hughes, Nicholas Schretzman, and Anthony Fassano with substantial assistance from senior paralegal Jan McGovern. The review is current as of December 31, 2011.

mutual fund prospectus because the adviser did not make the statements. The Supreme Court observed—in a timely statement as we roll toward a presidential election—"[e]ven when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit—or blame for what is ultimately said." 131 S. Ct. at 2302.

Third, in *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. —, 131 S. Ct. 1309, 179 L. Ed. 2d 398 (Mar. 22, 2011), an important case for the medical and pharmaceutical industries, the Supreme Court addressed whether reports of adverse events associated with a pharmaceutical product are material "absent a sufficient number of such reports to establish a statistically significant risk that the product is in fact causing the events." 131 S. Ct. at 1318–19. The Supreme Court rejected the application of any bright-line rule, observing that statistical evidence may not always be available and that an absence of such data "does not mean that medical experts have no reliable basis for inferring a causal link between a drug and adverse events." *Id.* at 1319.

Statute of Limitations and the Impact of *Merck*

While it is too soon to predict the full effect of these three Supreme Court decisions, we are already observing the ripple effects of the 2010 decision in *Merck & Co., Inc. v. Reynolds*, 559 U.S. —, 130 S. Ct. 1784, 176 L. Ed. 2d 582 (Apr. 27, 2010). *Merck* addressed the critical question of when the clock begins to tick on the statute of limitations for a Rule 10b-5 action. The Supreme Court rejected the inquiry notice standard applied by the appellate court, holding that the limitations period does not begin to run until a plaintiff discovers, or a reasonably diligent plaintiff would have discovered, the facts constituting the violation. Importantly, the Supreme Court held that the "facts showing scienter are among those that 'constitut[e] the violation.'" 130 S. Ct. at 1796 (alteration in original).

In 2011, applying *Merck*, the Second and Ninth Circuits both reversed decisions in favor of defendants on statute of limitations grounds. *See City of Pontiac v. MBIA, Inc*., 637 F.3d 169 (2d Cir. Feb. 28, 2011); *Strategic Diversity Inc. v. Alchemix Corp*., — F.3d —, Nos. 10-15256, 10-16404, 2011 WL 6004607 (9th Cir. Dec. 2, 2011), *opinion withdrawn, reissued, and reh'g denied*, — F.3d —, 2012 WL 164091 (9th Cir. Jan. 20, 2012). In *City of Pontiac*, the Second Circuit held that under *Merck*, "a fact is not deemed 'discovered' until a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint" with sufficient particularity "to survive a 12(b)(6) motion to dismiss." *City of Pontiac*, 637 F.3d at 175.

The Seventh Circuit also addressed the key question of when a "violation" occurs such that the statute of repose begins to run. In *McCann v. Hy-Vee, Inc*., 663 F.3d 926 (7th Cir. Nov. 22, 2011), the plaintiff argued that the repose period runs from the time when she suffered injury. The Seventh Circuit rejected this argument, holding that the "violation" occurs at the time of the misstatement; otherwise

> a person who had bought a security could, having later discovered he'd been defrauded, wait indefinitely to determine whether his purchase had been a mistake (because of the fraud) on a windfall (because despite the fraud the price of the security had risen beyond expectations), since his two-year [statute of limitations period] would not run until the fraud causes him harm. This would be a heads I win, tails you lose proposition, which the law would be unlikely to countenance.

Id. at 931.

Financial Services and the Credit Crisis

In 2011, the circuit courts issued a number of decisions touching on the financial services industry and cases arising out of the credit crisis.

There were three decisions favorable to the financial industry arising out of the freeze in the auction rate securities (ARS) market. In *Ashland, Inc. v. Oppenheimer & Co., Inc.*, 648 F.3d 461 (6th Cir. July 28, 2011), the Sixth Circuit affirmed dismissal of an investor's claims based on insufficient allegations of scienter. Applying the holistic review of allegations required by *Tellabs v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), the Sixth Circuit found that the investor's allegations failed to give rise to a strong inference of scienter; "the more compelling explanation is that the near-spontaneous collapse of the ARS market caught Oppenheimer and its employees off guard." *Oppenheimer*, 648 F.3d at 470. In *Ashland Inc. v. Morgan Stanley & Co., Inc.*, 652 F.3d 333 (2d Cir. July 28, 2011), and *Wilson v. Merrill Lynch & Co., Inc*., No. 10-1528, 2011 WL 5515958 (2d Cir. Nov. 14, 2011), the Second Circuit twice affirmed the dismissal of claims that a dealer misrepresented the liquidity of auction rate securities where the dealer had posted certain disclosures concerning bidding practices and risks associated with auction rate securities in accordance with a prior Securities and Exchange Commission (SEC) settlement. In doing so in the *Merrill* action, the Second Circuit rejected the position of the SEC set forth in an amicus brief.

There were also two published appellate decisions concerning mortgage-backed securities (MBS). In *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp*., 632 F.3d 762 (1st Cir. Jan. 20, 2011), the plaintiffs challenged statements in MBS offering statements. The First Circuit held that the plaintiffs did not have standing to pursue claims with respect to trusts whose certificates they did not purchase and for offerings in which they did not participate. However, the First Circuit allowed to proceed those claims of alleged misstatements concerning underwriting standards, finding that the risk warnings disclosed in the offering materials did not address the plaintiffs' claims of "wholesale abandonment of underwriting standards." *Id.*

With respect to *In re Lehman Bros. Mortgage-Backed Sec. Litig.*, 650 F.3d 167 (2d Cir. May 11, 2011), the Second Circuit affirmed the dismissal of claims against rating agencies under Sections 11 and 15 of the Securities Act of 1933 in connection with investments in mortgage pass-through certificates. The Second Circuit rejected the plaintiffs' claim that the rating agencies should be deemed liable as underwriters or control persons.

On the Bernie Madoff front, the Second Circuit rejected efforts to hold a financial institution liable under RICO for allegedly aiding and abetting the Madoff fraud, finding the claims were barred by the so-called "RICO Amendment" to the Private Securities Litigation Reform Act of 1995 (PSLRA). The plaintiff argued that the RICO Amendment does not apply to aiding and abetting claims because the securities laws do not provide a private right of action for such claims. The Second Circuit rejected this argument: "[S]ection 107 of the PSLRA bars civil RICO claims alleging predicate acts of securities fraud, even where a plaintiff cannot itself pursue a securities fraud action against the defendant." *MLSMK Inv. Co. v. JP Morgan Chase & Co*., 651 F.3d 268, 277 (2d Cir. July 7, 2011). The question of whether the Securities Litigation Uniform

Standards Act of 1998 (SLUSA) applies to state law claims brought by victims of the Madoff scheme has been argued and is currently awaiting a decision by the Second Circuit. *Barron v. Igolnikov*, No. 101387 (2d. Cir. *argument heard* Mar. 1, 2011).

Also, in 2009 and 2010, we observed that claims against accounting firms were repeatedly failing on appeal. In 2011, the results were more mixed. In *In re DVI, Inc. Sec. Litig*., 639 F.3d 623 (3d Cir. Mar. 29, 2011), the Third Circuit affirmed an order certifying a class against an issuer's outside auditor, holding that loss causation need not be established to invoke the fraud-on-the-market presumption. This decision was consistent with the Supreme Court's decision in *Halliburton*, issued several months later. Shortly after *DVI*, the Ninth Circuit reversed an order of dismissal and reinstated claims against an outside auditor in connection with alleged stock option backdating by one of its clients. *See N.M. State Inv. Council v. Ernst & Young LLP*, 641 F.3d 1089 (9th Cir. Apr. 14, 2011). In doing so, the Ninth Circuit declined to set a special scienter standard for accountants. In contrast, the Tenth Circuit declined to reach the question of whether a more "stringent" scienter requirement should apply to outside auditors, but nonetheless affirmed dismissal of claims against an auditor in *Dronsejko v. Thornton*, 632 F.3d 658, 665 (10th Cir. Jan. 20, 2011).

Scienter

With respect to more general trends at the circuit court level, there were a number of defense-oriented decisions on scienter. For example, in the *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Waters Corp*., 632 F.3d 751 (1st Cir. Jan. 20, 2011), the First Circuit declined to find scienter based on an alleged failure of a technology company to disclose changes in regulations in a foreign market that subsequently affected product demand, where the defendants had made statements to the market about the decrease in demand. Similarly, in *Miss. Pub. Emps. Ret. Sys. v. Bos. Scientific Corp.,* 649 F.3d 5 (1st Cir. Aug. 4, 2011), the First Circuit issued a lengthy opinion tracking the history and manufacturing process of coronary stents before holding that the plaintiff failed to produce evidence at the summary judgment stage that would permit a reasonable inference of scienter in connection with alleged failures to disclose a product defect. "The investing public was not only aware of the no-deflate complaints, but also the risk of recall, which defendants openly discussed." *Id*. at 29.

The Eighth Circuit also refused to find that a plaintiff adequately pleaded scienter arising in connection with an alleged failure to disclose problems at an operating plant, where the defendant had disclosed operating plant problems both before and after the class period. In *Minneapolis Firefighters' Relief Ass'n v. MEMC Elec. Materials, Inc*., 641 F.3d 1023 (8th Cir. June 17, 2011), the Eighth Circuit observed that there was no precedent supporting the plaintiff's "pattern" theory of scienter. *Id.* at 1030.

However, claims against two executives associated with a now-bankrupt auto parts manufacturer were found be sufficient, in light of the holistic review of facts required under *Tellabs*. In *Frank v. Dana Corp*., 646 F.3d 954 (6th Cir. May 25, 2011), *reh'g and reh'g en banc denied* (July 1, 2011), the Sixth Circuit observed that the defendants "were the two top executives of an auto parts manufacturer, and they reported gangbuster earnings during a period of time when the entire auto industry was spiraling towards bankruptcy." *Id*. at 961.

Reliance, Materiality, and Causation

As noted above, the Supreme Court concluded in *Halliburton* that a plaintiff need not establish loss causation at the class certification stage to invoke the fraud-on-the-market theory of reliance. The Ninth Circuit added that a plaintiff also need not prove materiality at class certification. "As for the element of materiality, the plaintiff must plausibly allege—but need not *prove* at this juncture—that the claimed misrepresentations were material." *Conn. Ret. Plans & Trust Funds v. Amgen, Inc.*, 660 F.3d 1170, 1172 (9th Cir. Nov. 8, 2011).

Also focusing on materiality, the Second Circuit issued two important decisions. In *Litwin v. Blackstone Group, L.P.*, 634 F.3d 706 (2d Cir. Feb. 10, 2011), the Second Circuit vacated an order of dismissal of claims brought on behalf of purchasers of initial public offering (IPO) shares of Blackstone alleging that the defendants knew about, but failed to disclose, alleged problems with two portfolio companies and a fund investment. The district court (S.D.N.Y.) applied both a qualitative and quantitative approach, comparing the alleged misstatement with the entire financial position of Blackstone, in assessing materiality. The Second Circuit criticized this approach, holding that a misstatement that appears "quantitatively small" compared with firmwide financial results can still be material if it is significant to a "particularly important segment" of the firm's business. *Id*. at 720.

Several months later, the Second Circuit revisited the question of materiality in *Hutchison v. Deutsche Bank Sec. Inc.*, 647 F.3d 479 (2d Cir. July 26, 2011). In *Hutchison*, the plaintiffs alleged misrepresentations and omissions concerning impairment of two mezzanine loans totaling approximately $51.5 million out of a total investment portfolio of $1.1 billion of the defendant real estate finance company. The Second Circuit stated: "If a particular product or product line, or division or segment of a company's business, has independent significance for investors, then even a matter material to less than all of the company's business may be material for the purposes of the securities laws." *Id*. at 488. The Second Circuit then observed that while the two loans represented a significant portion of the real estate entity's outstanding mezzanine loans, the plaintiffs failed to allege that mezzanine loans constituted a particularly important segment of the business and therefore the proper comparison was to the entire portfolio.

As for loss causation, the Eleventh Circuit held that "confirmatory information that wrongfully *prolongs* a period of inflation—even without increasing the *level* of inflation—may be actionable under the securities laws." *FindWhat Investor Group v. FindWhat.com*, 658 F.3d 1282, 1314 (11th Cir. Sept. 30, 2011).

Popular Culture

Finally, in a part of the story not reflected in the Hollywood movie depicting the founding of the social computer network, the Ninth Circuit affirmed a district court (N.D. Cal.) decision enforcing a global settlement between the founders of Facebook. In *Facebook, Inc. v. Pacific Northwest Software, Inc.*, 640 F.3d 1034 (9th Cir. Apr. 11, 2011, amended May 16, 2011), the court rejected an attempt by three individuals to rescind a settlement agreement between them and Facebook by invoking Section 29(b) of the Securities Exchange Act of 1934.

As for 2012, we are monitoring whether the circuit courts continue the trend of limiting the types of defendants that may be targeted by the securities laws, as reflected in *Janus Capital*. We are similarly focused on cases reflecting restrictions on limitations defenses as a result of *Merck*, and we continue to analyze decisions addressing complex financial products and the impact of the financial crisis.

If you would like further information regarding this LawFlash, please contact any of the following Morgan Lewis attorneys:

New York

Bernard J. Garbutt III	212.309.6084	bgarbutt@morganlewis.com
Brian A. Herman	212.309.6909	bherman@morganlewis.com
Michael S. Kraut	212.309.6927	mkraut@morganlewis.com
Kevin T. Rover	212.309.6244	krover@morganlewis.com
John M. Vassos	212.309.6158	jvassos@morganlewis.com

Chicago

Kenneth M. Kliebard	312.324.1174	kkliebard@morganlewis.com
Scott T. Schutte	312.324.1173	sschutte@morganlewis.com

Philadelphia

J. Gordon Cooney, Jr.	215.963.4806	jgcooney@morganlewis.com
Timothy D. Katsiff	215.963.4857	tkatsiff@morganlewis.com
Karen Pieslak Pohlmann	215.963.5740	kpohlmann@morganlewis.com
William P. Quinn, Jr.	215.963.5775	wquinn@morganlewis.com
Marc J. Sonnenfeld	215.963.5572	msonnenfeld@morganlewis.com

San Francisco

Joseph E. Floren	415.442.1391	jfloren@morganlewis.com
Elizabeth A. Frohlich	415.442.1352	efrohlich@morganlewis.com

Washington, D.C.

Patrick D. Conner	202.739.5594	pconner@morganlewis.com
Christian J. Mixter	202.739.5575	cmixter@morganlewis.com

Miami

Ivan P. Harris	305.415.3398	iharris@morganlewis.com

Irvine

Robert E. Gooding, Jr.	949.399.7181	rgooding@morganlewis.com

About Morgan, Lewis & Bockius LLP

With 22 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states.
Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2012 Morgan, Lewis & Bockius LLP. All Rights Reserved.