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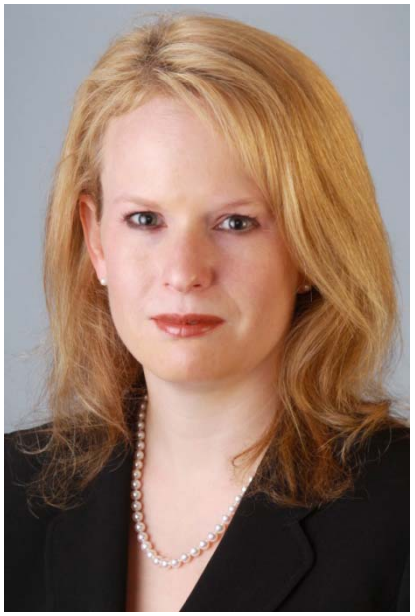
Restraining Securities Fraud Liability

Developments In Class Certification and Third-Party Liability

June 6, 2012

Speakers



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The Importance of Class Certification

- As a practical matter, the class certification stage can be the last and best chance for a defendant to avoid the enormous discovery, disruption, and settlement costs of most securities fraud suits.
- Although some courts see class actions as a routine and essential protection for investors, many courts also recognize that certifying a class action exerts an "in terrorem" effect that allows plaintiffs to wring "blackmail settlements" from defendants.
- Using Rule 23(f), appellate courts have made clear that not every suit—and not every securities fraud suit—should be a class action.
- The law developed over the last 15 years has identified many avenues for challenging class certification in securities fraud suits.

Class Certification Requirements

- Rule 23(a) has four threshold requirements for all class actions: (1) numerosity; (2) commonality; (3) typicality; and (4) adequacy.
- Ascertainability is also considered a threshold requirement.
- Rule 23(b)(3) adds two requirements: (1) predominance; and (2) superiority.
- Predominance—whether questions common to the class predominate over questions affecting only individual members—is usually the focus of class certification disputes in securities fraud suits.
- In practice, predominance will be absent when a central element of liability or a key defense requires claimant-specific inquiries to resolve and is legitimately in dispute for many claimants.

Knowledge as an Obstacle to Class Certification

- Under the federal securities laws, a defendant is not liable for alleged misstatements to anyone who knew the "truth" when making the securities trade at issue.
- Lack of knowledge is an element of claims under Section 10(b) of the Securities Exchange Act and Section 12(a)(2) of the Securities Act.
- Knowledge is an affirmative defense to claims under Section 11 of the Securities Act.

Knowledge as an Obstacle to Class Certification

- The knowledge of putative class members cannot be determined with common evidence because it varies by class member.
- Only individual inquiries inconsistent with class certification can prove whether class members knew the "truth" behind alleged misstatements.
- Thus, individual issues will predominate and class certification will be inappropriate when more than a minimal number of class members may have had knowledge that would defeat their claims.

Knowledge as an Obstacle to Class Certification

- Several decisions have denied class certification in securities fraud suits because individual knowledge inquiries were necessary.
- *IPO Securities Litigation* (2d Cir.): Class members would have learned of the alleged scheme to inflate stock prices through past participation in IPOs or through television and print reports on the challenged practices.
- *New Jersey Carpenters v. Residential Capital* (SDNY): Class members had different levels of knowledge because many were sophisticated and experienced investors in asset-backed securities and all bought at different times relative to government actions, analyst reports, news items, and raw data that revealed the "truth" over the class period. Affirmed by the Second Circuit.
- *Superior Offshore* (SD Tex.): Public statements from the issuer and analysts revealed some, but not all, of the supposedly misstated information about the issuer's plans and prospects.
- *Zimmerman v. Bell* (4th Cir.): Media coverage of tender offers disclosed information allegedly omitted from the solicitation.

Knowledge as an Obstacle to Class Certification

- Other decisions have rejected arguments that individual knowledge inquiries were necessary and precluded class certification.
- *MissPERS v. Goldman Sachs* (SDNY): No evidence that putative class members actually knew of matters misstated in MBS offering documents.
- *New Jersey Carpenters v. DLJ Mortgage* (SDNY): The public reports on the matters misstated were insufficient to create individual knowledge issues and there was no evidence of class members with actual knowledge.
- *MissPERS v. Merrill Lynch* (SDNY): Evidence of actual knowledge was "weak" and there was no evidence that class members participated in the allegedly hidden mortgage practices.

Knowledge as an Obstacle to Class Certification

- When opposing class certification on knowledge grounds, it is important to develop as much evidence as possible that particular class members actually knew the "truth" about the alleged misstatements.
- That evidence can come from: (1) class member admissions; (2) broker or advisor statements; (3) the experience and sophistication of the putative class; (4) public revelations of the "truth" by issuers, the media, and analysts; (5) discussions from internet chat rooms and other investor forums; and (6) expert opinion on the dissemination of "truth."
- Crucially, a defendant does not need to come forward with evidence sufficient to prove individual knowledge defenses on the merits. It is enough to show that individual knowledge inquiries might be necessary. (*N.J. Carpenters v. RALI Series 2006-QO1 Trust* (2d Cir.))

Materiality and Price Impact in Class Certification

- To prevail on a claim under Section 10(b) of the Securities Exchange Act, a plaintiff must prove reliance on an alleged misstatement.
- Section 11 of the Securities Act also requires proof of reliance by anyone who purchased after the issuer published earning statements covering one year following the registration statement containing the alleged misstatement.
- Ordinarily, reliance would be an individual issue that would prevent class certification.

Materiality and Price Impact in Class Certification

- In *Basic v. Levinson*, the Supreme Court held that reliance on public, material misstatements could be presumed in securities fraud suits if the security at issue traded in an open and developed market.
- *Basic* also held that the presumption of reliance could be rebutted by "any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff or his decision to trade at a fair market price."
- Among other possible rebuttal evidence, *Basic* referenced proof that "the market price would not have been affected by [the] misrepresentations."
- In *Erica P. John Fund v. Halliburton*, the Supreme Court said that a plaintiff did not have to prove loss causation to obtain the presumption of reliance, but it expressly declined to decide whether and how the price impact of misstatements would affect the presumption of reliance and class certification.

Materiality and Price Impact in Class Certification

- If the presumption of reliance never arises or is rebutted, reliance must be proved individually and a class should not be certified.
- Courts widely agree that reliance may not be presumed and class certification should be denied when the misstatement was not publicly known, the relevant security did not trade in an efficient market, or the transactions at issue occurred after the "truth" was revealed.
- But federal courts are deeply divided over whether class certification should be denied when the alleged misstatements are not material or did not have any price impact.

Materiality and Price Impact in Class Certification

- Some courts hold that a lack of materiality or price impact precludes the presumption of reliance needed for class certification.
- *Salomon Analyst Metromedia* (2d Cir.): A plaintiff must prove materiality to obtain the presumption and a defendant can rebut the presumption by showing that the alleged misstatement had no price impact.
- *Oscar Private Equity Inv. v. Allegiance Telecom* (5th Cir.): A plaintiff must show materiality to obtain the presumption and proof refuting any price impact will rebut the presumption.
- *DVI Securities Litigation* (3d Cir.): A defendant can rebut the presumption by showing that the misstatements were not material or did not affect the market price.
- *Polymedica* (1st Cir.) & *Gariety* (4th Cir.): Dicta requiring plaintiffs to prove materiality to obtain the presumption.

Materiality and Price Impact in Class Certification

- Other courts have held that materiality and price impact are not grounds for withholding the presumption of reliance at the class certification stage.
- *Schleicher v. Wendt* (7th Cir.): Materiality and price impact are not relevant to the class certification decision.
- *Connecticut Retirement Plans v. Amgen* (9th Cir.): At the class certification stage, a plaintiff need not prove materiality to obtain the presumption and a defendant cannot rebut the presumption with proof of a "truth on the market" defense.

Materiality and Price Impact in Class Certification

- A petition for certiorari is pending in *Connecticut Retirement Plans*.
- It is hard to square the holdings in *Connecticut Retirement Plans* and *Schleicher* with what *Basic* says about how the presumption of reliance arises and may be rebutted.
- The importance of the class certification decision counsels against restricting the kind of challenges to the presumption of reliance that defendants may raise at the class certification stage.

Nearly One Year After *Janus v. First Derivative Traders*

The Impact on Third Party Liability

The *Janus Holding*

"For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."

"We draw a clean line. . . . [T]he maker is the person or entity with ultimate authority over a statement and others are not."

Potential Ambiguity

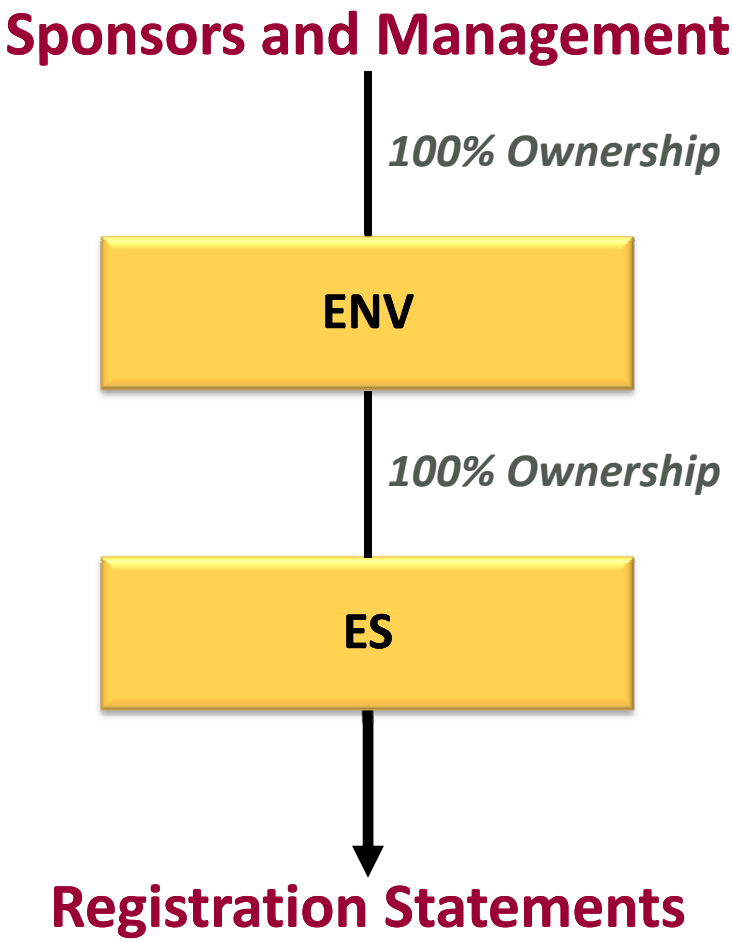
"For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.

. . . . . .

And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by–and only by–the party to whom it is attributed."

131 S.Ct. at 2302

City of Roseville Employees' Retirement Sys. v. EnergySolutions, Inc., 2011 WL 4527328 (S.D.N.Y. Sept. 30, 2011)



City of Roseville Employees' Retirement Sys. v. EnergySolutions, Inc., 2011 WL 4527328 (S.D.N.Y. Sept. 30, 2011)

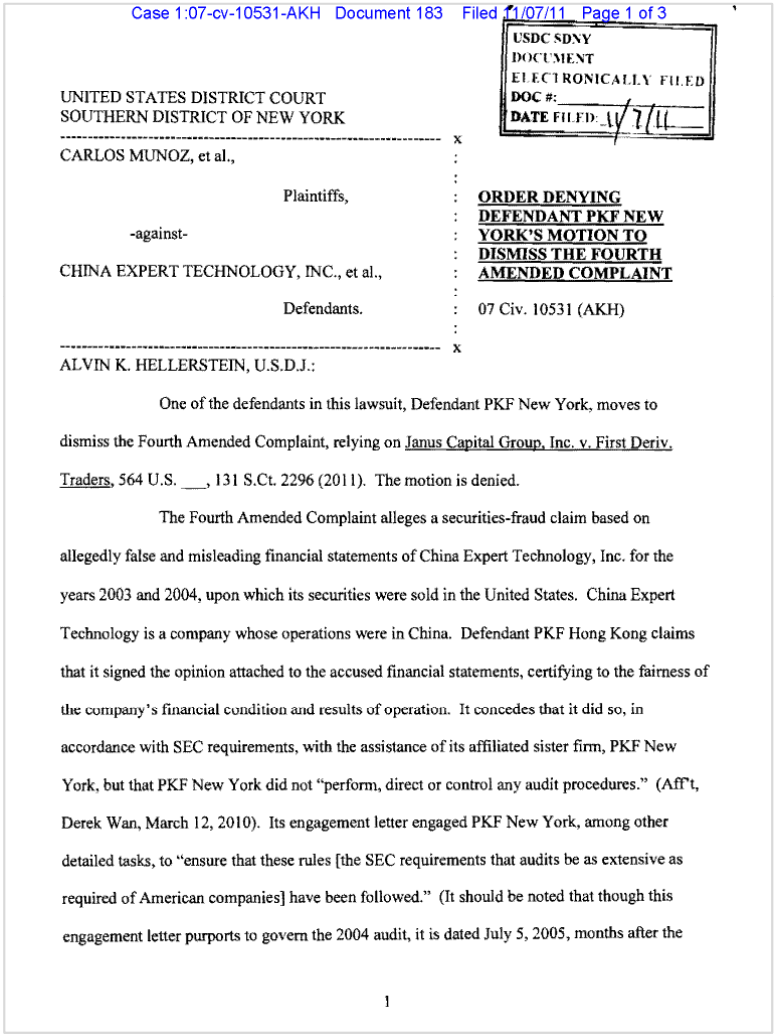
De Facto Ultimate Authority Found

- ENV was sole owner of ES pre-IPO/selling stockholder in the IPO.
- ENV to retain control post-IPO.
- Registration Statement said ES would be "controlled company" post-IPO.
- Sponsors controlled ES through ENV – "ENV therefore had 'ultimate authority' over the two Offerings, as required by Janus." (*18)
- "Janus recognized that attribution could be 'implicit from the surrounding circumstances.' Here, where the Registration Statements contain so many indicia of control, the lack of an explicit statement that ENV was speaking through the Registration Statements does not control the answer to the question of whether it made those statements. A reasonable jury could find that, on the facts alleged here, ENV's role went well beyond that of 'a speechwriter draft[ing] a speech.' . . ." (*18)

Munoz v. China Expert Technology, Inc., No. 1:07-cv-10531-AKH (S.D.N.Y. Nov. 4, 2011)

- PKF Hong Kong audited financial statements of China-based registrant.
- PKF New York served as the Filing Reviewer per Appendix K. The audit report was signed by PKF without delineating what PKF entity was the signer.
- Despite the holding in *Janus*, PKF New York's motion to dismiss was denied.

Munoz v. China Expert Technology, Inc., No. 1:07-cv-10531-AKH (S.D.N.Y. Nov. 4, 2011)



UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

CARLOS MUNOZ, et al.,

Plaintiffs,

-against-

CHINA EXPERT TECHNOLOGY, INC., et al.,

Defendants.

ORDER DENYING DEFENDANT PKF NEW YORK'S MOTION TO DISMISS THE FOURTH AMENDED COMPLAINT

07 Civ. 10531 (AKH)

ALVIN K. HELLERSTEIN, U.S.D.J.:

One of the defendants in this lawsuit, Defendant PKF New York, moves to dismiss the Fourth Amended Complaint, relying on Janus Capital Group, Inc. v. First Deriv. Traders, 564 U.S. ___, 131 S.Ct. 2296 (2011). The motion is denied.

The Fourth Amended Complaint alleges a securities-fraud claim based on allegedly false and misleading financial statements of China Expert Technology, Inc. for the years 2003 and 2004, upon which its securities were sold in the United States. China Expert Technology is a company whose operations were in China. Defendant PKF Hong Kong claims that it signed the opinion attached to the accused financial statements, certifying to the fairness of the company's financial condition and results of operation. It concedes that it did so, in accordance with SEC requirements, with the assistance of its affiliated sister firm, PKF New York, but that PKF New York did not "perform, direct or control any audit procedures." (Aff't, Derek Wan, March 12, 2010). Its engagement letter engaged PKF New York, among other detailed tasks, to "ensure that these rules [the SEC requirements that audits be as extensive as required of American companies] have been followed." (It should be noted that though this engagement letter purports to govern the 2004 audit, it is dated July 5, 2005, months after the

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Munoz v. China Expert Technology, Inc., No. 1:07-cv-10531-AKH (S.D.N.Y. Nov. 4, 2011)

In the case at hand, the relationship is not so clear-cut. Plaintiffs have properly pleaded that PKF New York exercised more than assistance. According to their complaint, not only did PKF New York participate in the audits, but it also exercised authority over what was said in the audit opinion. Indeed, the PKF New York engagement letter specifically stated that PKF New York would "review the entire filings with the SEC for compliance." Furthermore, according to the complaint, PKF New York's Managing Director gave final approval of the opinions before they were signed, and then the audit documents were simply signed "PKF" with no indication as to which corporate entity issued them. These allegations, and others, create genuine issues of fact as to whether PKF New York explicitly or implicitly controlled sufficiently—and thus "made"—the statements in question. To determine such issue, discovery is required. PKF New York may renew its motion after discovery closes to allow me to re-examine the issue upon all the relevant facts.

Other Cases Have Faithfully Applied *Janus*: *Fulton v. MGIC , 2012* WL 1216314 (7th Cir. Apr. 12, 2012)

- The Facts
  - Credit-Based Asset Servicing and Securitization LLC (C-BASS) is a joint venture between MGIC and Radian Group Inc., each of which owns 46% of C-BASS.
    - The Remaining 8% of C-Bass is owned by its managers.
  - C-BASS bought and packaged single-family residential mortgage loans (mostly subprime) and sold the securitized loans.
  - Plaintiffs alleged that false statements were made about the liquidity of C-BASS.

The *Fulton* Court's Application of *Janus*

- Plaintiffs claimed MGIC was directly liable under Section 10(b) because MGIC invited C-BASS's officers to speak and "effectively 'made' their statements itself."
  - The court rejected this argument based on plaintiffs' failure to allege that MGIC directed any statements of C-BASS's officers. The court said the C-BASS officers appeared to be "independent agents, speaking for themselves (and of course for C-BASS . . .)."
- In the alternative, plaintiffs argue that MGIC had a duty to correct errors in the statements of C-BASS's officers.
  - The court also rejected this argument finding that no such duty exists (and noting that, if such a duty did exist, *Janus* would have come out the other way).

Other Interesting *Janus* Cases and Issues

- The Group Pleading Doctrine: *Janus* "casts doubt" on group pleading doctrine for Section 10(b) claims. *Orlan v. Spongtech Delivery Systems, In. Securities Litigation*, 2012 WL 1067975 (E.D.N.Y. 2012).
- An attorney can be liable for false statements when the statements are made by him and not prepared by the client. *SEC v. Boyd*, 2012 WL 1060034 (D. Col. 2012).
  - See also *SEC v. Mercury Interactive, LLC*, 2011 WL 5871020 (N.D. Cal. Nov. 22, 2011) (finding liability under *Janus* for outside counsel and former General Counsel who signed the misleading proxy statements)
- The law is unsettled as to whether the SEC is restricted by *Janus*. Compare *SEC v. Pentagon Capital Management PLC*, 2012 WL 479576 (S.D.N.Y. 2012) (not applicable to SEC) with *SEC v. Kelly*, 2011 U.S.Dist. Lexis 108805 (S.D.N.Y. 2011) and *In the Matter of Flannery*, File No. 3-14081 (October 28, 2011), on appeal to Commission.

SEC v. Perry, 2012 WL 1959566 (C.D. Cal. May 31, 2012)

- Facts
  - IndyMac Bancorp offered a Direct Stock Purchase Plan (DSPP) whose prospectuses contained false or misleading information about Bancorp's financial health
  - SEC brought suit against Perry (CEO) and Keys (CFO)
- Court grants Δ's MSJ under *Janus*, and extends its reach to cover § 17(a) actions
  - "Defendants did not **prepare, review**, or **sign** the prospectuses, and thus were not the 'makers' of the statements contained therein. . . . Although Defendants signed the Form S–3 registration statement, they did so more than a year before the prospectuses were filed." (*8)
  - "This requirement applies to claims under **both** Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 promulgated thereunder, **and** Section 17(a) of the Securities Act of 1933." (*Ibid.*)

Extensions of the *Janus* Rule for 3d-party Liability

- Most courts have read *Janus* very narrowly, limiting its application strictly to Rule 10b-5(b) actions
  - E.g., *Lopes v. Viera*, 2012 WL 691665 (E.D. Cal. Mar. 2, 2012); *SEC v. Pentagon Capital Mgmt.*, 2012 WL 479576 (S.D.N.Y. Feb. 14, 2012); *SEC v. Mercury Interactive*, 2011 WL 5871020 (N.D. Cal. Nov. 22, 2011); *SEC v. Boock*, 2011 WL 5417106 (S.D.N.Y. Nov. 9, 2011); *SEC v. Geswein*, 2011 WL 4541303 (N.D. Ohio Sept. 29, 2011)
- Reason: SCOTUS' holding was about defining the word "make," which does not appear in R. 10b-5(b) or (c)
  - **Exception**: *SEC v. Kelly*, 817 F. Supp. 2d 340 (S.D.N.Y. 2011), in which the court extended *Janus* to R. 10b-5(a) & (c) as well, lest they become "back doors" for plaintiffs
- Another reason: SCOTUS was animated by limiting the implied private right of action—therefore, *Janus* does not apply to SEC actions pursuant to, e.g., §§ 14(a), 17(a), 34(b)
  - E.g., *SEC v. Sentinel Mgmt. Grp.*, 2012 WL 1079961 (N.D. Ill. Mar. 30, 2012); *SEC v. Daifotis*, 2011 WL 4714250 (N.D. Cal. Oct. 7, 2011); *SEC v. Carter*, 2011 WL 5980966 (N.D. Ill. Nov. 28, 2011)
  - **But see** *SEC v. Perry*, 2012 WL 1959566 (C.D. Cal. May 31, 2012) (*Janus* extends to § 17(a) claims as well); *In re Flannery*, 2011 WL 5130058 (SEC Release No. 438) (same)

Ironically, *Janus* Is Applied Narrowly in Securities Actions, but Read Broadly in Other Contexts

- As the previous slide shows, courts have read *Janus* very narrowly in the securities litigation context, declining to extend its application
  - E.g., to N.Y. common-law fraud claims: *In re Optimal U.S. Litig.*, 2011 WL 6424988 (S.D.N.Y. Dec. 21, 2011*); Allstate Ins. Co. v. Countrywide Fin. Corp.*, 824 F.Supp.2d 1164 (C.D. Cal. 2011)
  - E.g., to N.M. securities law claims: *Genesee County Emps.' Ret. Sys. v. Thornburg Mortg. Sec. Trust*, 825 F.Supp.2d 1082 (D.N.M. 2011)
  - E.g., to common-law misrepresentation claims : *King Cnty., Wash. v. IKB Deutsche Industriebank AG*, 2012 WL 1592193 (S.D.N.Y. May 4, 2012)
- On the other hand, some courts and judges take broad lessons from *Janus* outside of the securities context
  - E.g., if no 10b-5 liability for investment advisor, then no whistleblower protection under Sarbanes-Oxley either: *Lawson v. FMR LLC*, 670 F.3d 61 (1st Cir. 2012)
  - E.g., need not be totally deferential to SEC viewpoints in private causes of action (*Wilson v. Merrill Lynch & Co*, 671 F.3d 120 (2d Cir. 2011); *Frame v. City of Arlington*, 657 F.3d 215 (5th Cir. 2011)
  - E.g., if no 10b-5 liability for investment advisor, then no labor law liability either: *Oaktree Capital Mgmt. v. NLRB*, 452 Fed. Appx. 433 (5th Cir. 2011) (Jones, J., dissenting)

What Is Enough to Trigger 3d-party Liability Post-*Janus*?

- Signing a document
  - E.g., *In re Stillwater Capital Partners Inc. Litig.*, 2012 WL 1416837 (S.D.N.Y. Apr. 23, 2012); *City of St. Clair Shores Gen. Emps.' Ret. Sys. v. Lender Processing Servs.*, 2012 WL 1080953 (M.D. Fla. Mar. 30, 2012); *SEC v. Carter*, 2011 WL 5980966 (N.D. Ill. Nov. 28, 2011), *SEC v. Das*, 2011 WL 4375787 (D. Neb. Sept. 30, 2011); *Local 703, I.B.&T. Grocery & Food Emps. Welfare Fund v. Regions Fin. Corp.*, 2011 U.S. Dist. LEXIS 93873 (N.D. Ala. Aug. 23, 2011)
- Attribution within a document prepared by someone else
  - *In re Allstate Life Ins. Co. Litig.*, 2012 U.S. Dist. LEXIS 72900 (D. Ariz. May 24, 2012), *Lopes v. Viera*, 2012 WL 691665 (E.D. Cal. Mar. 2, 2012), *In re Nat'l Century Fin. Enters., Inc.*, 2012 WL 685495 (S.D. Ohio Mar. 2, 2012); *SEC v. Radius Capital Corp.*, 2012 WL 695668 (M.D. Fla. Mar. 1, 2012); *Valentini v. Citigroup, Inc.,* 2011 WL 6780915 (S.D.N.Y. Dec. 27, 2011); *SEC v. Daifotis*, 2011 WL 4714250 (N.D. Cal. Oct. 7, 2011)

What Is Enough to Trigger 3d-party Liability Post-*Janus*?

- Listed on the cover page
  - *In re BP PLC Sec. Litig.*, 2012 WL 468519 (S.D. Tex. Feb. 13, 2012); *In re Nat'l Century Fin. Enters., Inc.*, 2012 WL 685495 (S.D. Ohio Mar. 2, 2012)
- Reviewing the document before release
  - *Munoz v. China Expert Tech., Inc.*, 2011 U.S. Dist. LEXIS 128539 (S.D.N.Y. Nov. 7, 2011); *Liberty Media Corp. v. Vivendi Universal, S.A.*, 2012 WL 1203825 (S.D.N.Y. Apr. 11, 2012)
- Drafting an attachment to a document
  - *In re Stillwater Capital Partners Inc. Litig.*, 2012 WL 1416837 (S.D.N.Y. Apr. 23, 2012)
- Filling out SEC forms with false information
  - *SEC v. Radius Capital Corp.*, 2012 WL 695668 (M.D. Fla. Mar. 1, 2012)

How to Avoid Liability Under Janus

- If someone else actually made the statement
  - *In re Coinstar Inc. Sec. Litig.*, 2011 WL 4712206 (W.D. Wash. Oct. 6, 2011)
- Substantial contribution is no longer enough to trigger liability
  - *In re Allstate Life Ins. Co. Litig.*, 2012 U.S. Dist. LEXIS 72900 (D. Ariz. May 24, 2012)
- Neither preparing nor reviewing the prospectus, and signing the Form S-3 registration a year before the prospectus was filed
  - *SEC v. Perry*, 2012 WL 1959566 (C.D. Cal. May 31, 2012)
- An defendant's picture accompanies the false statement, but without explicit attribution to him
  - *SEC v. Daifotis*, 2011 WL 4714250 (N.D. Cal. Oct. 7, 2011)
- Group-pleading doctrine—unclear if it survives *Janus*
  - *Orlan v. Spongetech Delivery Sys., Inc., Sec. Litig.*, 2012 WL 1067975 (E.D.N.Y. Mar. 29, 2012); *Rolin v. Spartan Mullen Et Cie, S.A.,* 2011 WL 5920931 (S.D.N.Y. Nov. 23, 2011)