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Section 10(b) Litigation: The Current Landscape

By Jay B. Kasner and Mollie M. Kornreich

Shareholder lawsuits for violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) are a common source of liability for public companies. These cases are often triggered by nothing more than a drop in stock price, after which shareholder plaintiffs allege that the change in price reflects newly public information that the company previously and improperly concealed.

Pleading Requirements

Section 10(b) makes it unlawful to "use or employ, in connection with the purchase or sale of any security" a "manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b). "Security" is defined broadly to include, among other things, stocks, bonds, debentures, a variety of other instruments, or, "in general, any instrument commonly known as a 'security.'" 15 U.S.C. § 78c(a)(10).

The SEC's implementing regulation, Rule 10b-5, further defines the scope of the statutory language. The rule renders it unlawful, in connection with the purchase or sale of any security, to:

- Employ any device, scheme, or artifice to defraud;
- Make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading; or
- Engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

See 17 C.F.R. § 240.10b-5 (2014).

Although the statute does not provide for an express private right of action to enforce Section 10(b) and Rule 10b-5, one has been implied since the mid-1940s. The Supreme Court has declined, however, to imply a private cause of action for aiding and abetting liability under the statute. *See Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 176–77, 179–80, 191 (1994). Notably, the SEC is not bound by this limitation. *See* 15 U.S.C. § 78t(e); *SEC v. U.S. Envtl.*, Inc., 155 F.3d 107, 113 (2d Cir. 1998).

To establish liability under Section 10(b), a plaintiff must show that:

- The defendant made a material misstatement or omission;
- The misstatement or omission was made with an intent to deceive, manipulate or defraud (that is, with scienter);
- There is a connection between the misrepresentation or omission and the plaintiff's purchase or sale of a security;
- The plaintiff relied on the misstatement or omission;
- The plaintiff suffered economic loss; and
- There is a causal connection between the material misrepresentation or omission and the plaintiff's loss.

See Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

Each of these elements has been the subject of numerous opinions and ample scholarship as the scope of liability under the statute continues to evolve.

Misstatement or Omission

Section 10(b) requires a defendant to have made a misstatement or omission. An omission may only give rise to liability if it was necessary to render another statement not misleading, or if the defendant had a duty to disclose.

Recently, in *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court addressed what it means to "make" an untrue statement under Section 10(b). It found that a mutual fund investment advisor could not be held liable for false statements in its clients' prospectuses, as it did not "make" the statements at issue. Rejecting the argument that liability could extend to the person who provided the false information, the Supreme Court held that "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." 131 S. Ct. 2296, 2300–02 (2011).

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Materiality

Only a material misstatement or omission can give rise to liability under Section 10(b) and Rule 10b-5. 17 C.F.R. § 240.10b-5. A fact is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making his investment decision. In determining materiality, the misstatement or omission is not viewed in a vacuum. Rather, the question is whether disclosure would have "significantly altered the 'total mix'" of available information.

Materiality is generally a mixed question of law and fact, and is decided as a matter of law only when "reasonable minds could not differ on" the statement's importance. *See, e.g., Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 717 (2d Cir. 2011) (internal quotation marks omitted). However, there are cases where this standard is met and alleged misstatements or omissions are deemed immaterial as a matter of law. For example, certain statements may be considered mere "puffery" when they are too general to induce a reasonable investor's reliance on them. *See, e.g., City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014).

The Supreme Court recently addressed materiality in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S.Ct. 1309 (2011). There, it considered whether a pharmaceutical company's failure to disclose adverse event reports associated with one of its products was material, where the reports did not disclose a "significant number of adverse events." The Court held that the plaintiffs had adequately pled materiality given the quality of the reports, the commencement of related product liability lawsuits, previous studies which lent credibility to the reports and the fact that the product in question allegedly accounted for 70% of the defendant's sales. Because these facts suggested "a significant risk to the commercial viability of [the defendant's] leading product," it was "substantially likely that a reasonable investor would have viewed this information as having significantly altered the total mix of information." (Internal quotation marks omitted.)

"In Connection with" a Purchase or Sale

It is well-settled that a private action under Section 10(b) can be brought only by a purchaser or seller of the security. 15 U.S.C. § 78j(b). *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730–31 (1975). Therefore, a potential buyer who was dissuaded from purchasing as a result of a fraudulent misstatement, or an investor who held a security and, in reliance on the alleged misstatement, did not sell it cannot bring suit. *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 79–80 (2006).

Recently, courts have focused on the "in connection with" requirement in determining the scope of the Securities Litigation Uniform Standards Act (SLUSA), which precludes certain state law class actions that allege a misrepresentation or omission of a material fact in connection with the purchase or sale of a "covered security." *See Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058, 1064 (2014); *Dabit*, 547 U.S. at 84.

Scienter

A plaintiff pursuing a Section 10(b) claim must demonstrate that the defendant acted with scienter, or the intent to deceive, manipulate or defraud. Although negligent conduct is insufficient to create liability, reckless conduct may satisfy this requirement, and the necessary degree of recklessness varies by Circuit. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 & n.3 (2007).

Under the Private Securities Litigation Reform Act (PSLRA), a plaintiff must also state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind. When evaluating whether a plaintiff has met this standard, a court "must consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff." A complaint will survive only where a reasonable person would deem the inference of scienter "cogent and at least as compelling as any opposing inference" that could be drawn from the facts alleged.

The formulation of the scienter standard adopted by the U.S. Court of Appeals for the Second Circuit is illustrative. Under that standard, a plaintiff may sufficiently plead scienter by alleging facts showing either that the defendant had both motive and opportunity to commit fraud, or strong circumstantial evidence of conscious misbehavior or recklessness. *See Novak v. Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000). Only an "extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it" may constitute recklessness severe enough to give rise to liability. Quotation marks omitted.)

Courts have found scienter to be insufficiently pled where, for example:

- The plaintiffs alleged that the defendant attempted to inflate its stock price to reduce the cost of acquiring another financial institution, among other things, and that the individual defendants were motivated to increase their compensation and bonuses. See *ECA & Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 200–01 (2d Cir. 2009).
- The plaintiffs' confidential witness allegations asserted that various managers at a subsidiary had knowledge of undisclosed customs violations, and that high-level officers of the defendant would meet with subsidiary management. *See Rahman v. Kid Brands, Inc.*, 736 F.3d 237, 243–44 (3d Cir. 2013).

Reliance

Reliance, sometimes called transaction causation, provides the requisite causal connection between an alleged misstatement or omission and the plaintiff's injury.

In cases involving affirmative misstatements, the most direct way to demonstrate reliance is to show that the plaintiff was aware of a company's statement and engaged in the relevant transaction based on that specific misrepresentation. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2185 (2011).

Where omissions are at issue, reliance may be presumed under certain circum-

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stances. In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), the Supreme Court held that where a plaintiff alleged that the defendant breached an affirmative duty to disclose certain information, the plaintiff did not need to show proof of reliance on the purported omission. Rather, it was enough to show that the withheld facts were material, or important to a reasonable investor. Under the *Ute* presumption, lack of reliance remains a viable defense in omission cases, effectively shifting the burden to the defendant to demonstrate that the plaintiff did not rely on the omission.

Another reliance presumption available to plaintiffs is based on the fairly controversial fraud on the market theory. Under this theory, plaintiffs are afforded a presumption that the prices of shares traded in an efficient market reflect any material misrepresentations. Therefore, the typical investor who buys or sells stock at the market price does so in reliance on the belief that the price reflects all public, material information. *See Halliburton v. Erica P. John Fund, Inc.*, 134 S. Ct. 2408, 2398 (2014). This commonly used presumption permits class action plaintiffs to avoid individualized issues of reliance when moving to certify a class.

To invoke the presumption, the plaintiffs must show that:

- The misrepresentations were public;
- The misrepresentations were material;
- The securities traded in an efficient market; and
- The plaintiffs traded between when the misstatements were made and when the truth was disclosed.

Recently, in *Halliburton Co. v. Erica P. John Fund, Inc.*, the Supreme Court clarified that defendants must be given the opportunity before class certification to defeat this presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock. If it did not, the prerequisites for establishing the presumption cannot be established. 134 S. Ct. at 2414.

Loss Causation

Under Section 10(b), a plaintiff must demonstrate loss causation, or a link between a misstatement or omission and the damages sought. Put differently, the misrepresented or concealed information must have negatively affected the stock price. *See Dura Pharms.*, 544 U.S. at 346.

A plaintiff often makes this showing by pointing to a subsequent disclosure that seeks to correct the alleged misstatement or omission and triggers a negative response from the market, commonly known as a corrective disclosure. *See, e.g., In re Omnicom Grp., Inc. Sec. Litig*., 597 F.3d 501, 511 (2d Cir. 2010).

Defending Section 10(b) Claims

Among other defenses to a Section 10(b) action, a defendant may assert that the plaintiff's claim does not involve securities listed on a U.S. exchange or a domestic transaction, or that the claim was not brought within the applicable statutory period.

Extraterritoriality

The Supreme Court has interpreted Section 10(b) to apply only to securities listed on domestic exchanges or domestic transactions in other securities. *See Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 273 (2010). Therefore, private claims under Section 10(b) are not actionable if the relevant securities were not listed on a US exchange and the purchase or sale did not occur within the US.

In considering whether a transaction involving securities that are not listed on a US exchange may be deemed domestic under *Morrison*, the Second Circuit has articulated a test that looks to whether "irrevocable liability is incurred or title passes within the United States." *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 67 (2d Cir. 2012).

Recently, the Second Circuit clarified that "while a domestic transaction or listing is *necessary* to state a claim under § 10(b)," it may not be *sufficient*. *Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE*, 11-397-CV L, 2014 WL 3973877 at *15 (2d Cir. Aug. 15, 2014). Thus, on the facts of that case, the Circuit found that a claim against foreign defendants based on "largely foreign conduct, for losses incurred by the plaintiffs . . . based on the price movements of foreign securities would constitute an impermissibly extraterritorial extension of the statute."

Timeliness

A plaintiff's ability to bring claims under Section 10(b) faces two temporal limitations, both of which must be satisfied: claims must be brought within two years of "discovery of the facts constituting the violation," and not more than five years after the alleged violation. 28 U.S.C. § 1658(b).

The two-year limitations period is triggered once the plaintiff discovers, or with reasonable diligence should have discovered, the facts constituting the violation, whichever comes first. *See Merck & Co. v. Reynolds*, 559 U.S. 633, 653 (2010). In other words, where the plaintiff never actually learned of the alleged fraud, the limitations period commences when "a reasonable investor conducting . . . a timely investigation would have uncovered the facts constituting a violation." *City of Pontiac Gen. Employees' Ret. Sys. v. MBIA, Inc*., 637 F.3d 169, 174 (2d Cir. 2011). A fact is sufficiently discovered in this context when "a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint."

The PSLRA and SLUSA

In 1995, Congress passed the PSLRA, which contained a number of procedural reforms applicable to Section 10(b) class actions, including, among other things:

- A heightened pleading standard that requires plaintiffs to identify each allegedly fraudulent statement; explain why each statement purportedly is fraudulent; state with particularity facts giving rise to a "strong inference" that the defendant acted with scienter; and plead and prove that the alleged misconduct caused the purported loss. 15 U.S.C. §§ 78u-4(b)(1)-(2), (4).
- A safe harbor for forward-looking statements that were accompanied by mean-

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ingful cautionary language or were not knowingly false when made. 15 U.S.C. § 78u-5(c)(1); *see also Slayton v. Am. Express Co.*, 604 F.3d 758, 765–66 (2d Cir. 2010).

- An automatic stay of discovery during the pendency of a motion to dismiss, absent a finding "that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to [either] party." 15 U.S.C. § 78u-4(b)(3)(B).
- A cap on damages that is limited to the difference between the price a plaintiff paid for a security and that security's mean trading price over the 90 days after corrective information was released to the market. 15 U.S.C. § 78u-4(e)(1).
- New procedures relating to appointment of class action plaintiffs and counsel, meant to ensure that the lead plaintiff has a significant stake in the litigation. 15 U.S.C. § 78u-4(a)(3).

Because of the new restrictions on who may be the lead plaintiff in a securities class action, lead plaintiffs are now usually institutional investors, who tend to have a larger financial stake in the company than individual shareholders.

To prevent plaintiffs from circumventing the PSLRA's requirements by filing state securities class actions, Congress passed SLUSA in 1998. SLUSA provides that no "covered class action" may be brought under state law by a private party alleging, among other things, "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A). If a class action that meets the statutory requirements is brought in state court, it may be removed to federal court and dismissed on preemption grounds. 15 U.S.C. §§ 78bb(f)(1)-(2).

The statute defines "covered class action" as any lawsuit or group of lawsuits, not including derivative suits, involving common questions of law or fact in which "damages are sought on behalf of more than 50 persons or prospective class members." 15 U.S.C. § 78bb(f)(5). The causes of action that are expressly excluded from SLUSA's reach and may be brought in state court include:

- State law claims arising in the proxy solicitation or tender offer context relating to an equity holder's decision on how to vote, or in exercising dissenters' rights or appraisal rights, commonly known as the Delaware carve-out. 15 U.S.C. § 78bb(f)(3)(A)(ii);
- Securities suits brought by a state, political subdivision of a state or state pension plan. 15 U.S.C. § 78bb(f)(3)(B); and
- Actions under contractual agreements between issuers and indenture trustees to enforce conditions of the indenture. 15 U.S.C. § 78bb(f)(3)(C).

The Supreme Court has addressed the scope of SLUSA preemption twice since the statute's enactment.

In *Dabit*, the Supreme Court held that SLUSA's preemption of state securities suits encompassed claims by plaintiffs who alleged to have held (rather than sold) securities in reliance on a misrepresentation. The Supreme Court reached this conclusion despite the fact that these "holder" plaintiffs also cannot bring a Section 10(b) action, resulting in complete preclusion of these class actions in either forum. The Court reasoned that the PSLRA and SLUSA were motivated by many of the same policy considerations regarding vexatious litigation that anchored the decision in *Blue Chip Stamps* to limit 10(b) claims to purchasers and sellers, and a narrow reading of the statutes would undercut that purpose. Further, use of Section 10(b)'s "in connection with the purchase or sale" requirement in SLUSA suggested congressional intent to give the language its settled judicial interpretation.

The Supreme Court recently interpreted SLUSA preemption again in *Chadbourne & Parke LLP*, 134 S. Ct. at 1065–66. Addressing the "in connection with the purchase or sale" language, it held that SLUSA did not preempt state law fraud claims involving the purchase of certificates of deposit, which were not covered securities. Because SLUSA's primary focus is on transactions in covered securities, the Supreme Court reasoned, SLUSA preemption applies only to matters "where the misrepresentation makes a significant difference to someone's decision to purchase or sell a covered security."

* * *

Eighty years after the Exchange Act was enacted, the scope of liability under Section 10(b) continues to evolve. While shareholder class actions may threaten companies with potentially large exposure, the PSLRA, SLUSA and several recent Supreme Court decisions have given defendants tools that may be effectively employed to halt meritless cases at the pleading or class certification stages.

Jay B. Kasner is a partner at Skadden, Arps, Slate, Meagher & Flom LLP, where he leads the firm's securities litigation practice. Mollie M. Kornreich is an associate in the firm's Litigation Department. *The above is based, in part, on an article the authors published in the August/September 2014 issue of Practical Law The Journal. This opinions expressed in this article are those of the authors and do not necessarily reflect the views of Skadden, Arps, Slate, Meagher & Flom LLP or its clients.*

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