THE RISE AND REFORMATION OF PRIVATE SECURITIES LITIGATION

JAY B. KASNER
PARTNER
SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP

Jay leads the firm's securities litigation practice and is widely recognized as one of the country's top litigators in securities, corporate and takeover litigation, and general commercial matters. He represents financial institutions and a diverse group of public companies and directors and officers in their most crucial securities matters. Jay has handled a number of precedent-setting securities cases throughout his career at the US Supreme Court, circuit court and district court levels.

MOLLIE M. KORNREICH
ASSOCIATE
SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP

Mollie is an associate in the firm's Litigation Department. Her experience includes a variety of complex commercial and securities matters.

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Securities class actions are a potential minefield for public companies, which may face enormous exposure as a result of these suits. To manage the financial and reputational risk associated with securities litigation, counsel and companies must stay informed of the governing rules and regulations, as well as the quickly changing judicial landscape.

Over time, the most common vehicle for private enforcement of the federal securities laws has become the shareholder class action. These cases are often triggered by nothing more than a drop in a public company's stock price, after which shareholder plaintiffs allege that the negative change in price reflects newly public information that the company previously and improperly concealed.

Although the securities laws have been amended to rein in the proliferation of dubious shareholder suits, securities class actions remain a minefield of exposure for public companies. Indeed, the past decade has seen six securities class action settlements in excess of $2 billion, and a recent report by National Economics Research Associates (NERA) found that the average settlement amount for federal securities class actions in 2013 was $68 million (*NERA, Recent Trends in Securities Class Action Litigation: 2013 Full-Year Review, at 27*, available at *nera.com*).

As Congress and the courts try to balance the need for full disclosure against the potential for frivolous securities class actions, the legal and regulatory landscape governing securities litigation has continued to change. Counsel and companies involved in these cases must stay informed of the relevant rules and regulations, as well as the evolving jurisprudence.

This article provides an overview of the development of securities litigation, with a particular focus on securities class actions and the latest standards created by the US Supreme Court and lower federal courts. It examines:

- Sources of liability in the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), including pleading standards under Section 10(b) of the Exchange Act.
- Key issues in shareholder class actions for violations of the securities laws, including the Private Securities Litigation Reform Act (PSLRA) and the Securities Litigation Uniform Standards Act (SLUSA).

SOURCES OF LIABILITY: THE SECURITIES ACT AND THE EXCHANGE ACT

The primary sources of civil liability under the federal securities laws are two New Deal-era statutes: the Securities Act and its close cousin the Exchange Act. The Securities Act regulates the offer and sale of securities, while the Exchange Act creates, among other things, ongoing reporting obligations for public companies.

"Security" is defined broadly under both statutes to include stocks, bonds, debentures, a variety of other instruments or, "in general, any interest or instrument commonly known as a 'security'" (*15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78c(a)(10); Marine Bank v. Weaver, 455 U.S. 551, 555-56 (1982)*). The Acts impose similar disclosure obligations, but their liability provisions differ in several key respects. Further, a private plaintiff may bring claims under both the Securities Act and the Exchange Act (see *Herman & MacLean v. Huddleston, 459 U.S. 375, 382-83 (1983)* (the availability of a Section 11 or 12 claim under the Securities Act does not preclude a Section 10(b) claim under the Exchange Act for the same conduct)).

Search US Securities Laws: Overview for information on the other key federal securities laws in the US, including the Sarbanes-Oxley Act of 2002, Trust Indenture Act, Investment Company Act and Investment Advisers Act.

LIABILITY UNDER THE SECURITIES ACT

The Securities Act focuses on potential misrepresentations or omissions that an issuer may make when offering securities for sale in the marketplace. It is based on the premise that investors are capable of evaluating the merits of a securities offering only if they are provided with accurate and complete information regarding the issuer, its securities and the offering.

Under the Securities Act, liability may generally be imposed on certain participants where publicly filed documents, used during a registered securities offering, "contain material misstatements or omissions" (*In re Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 358 (2d Cir. 2010)*). The three primary civil liability provisions are:

- Section 11.
- Section 12(a)(1).
- Section 12(a)(2).

(*15 U.S.C. § 77k; 15 U.S.C. § 77l(a)*.)

Counsel defending against claims brought under Section 11 or 12 have several statutory defenses at their disposal, but should be aware of certain nuances that ease a plaintiff's burden in establishing these claims.

Section 11

Section 11 establishes disclosure obligations in the context of any securities offering registered with the SEC. This section provides the buyer of a registered security with an express right of action if any part of the statement registering the security with the SEC "contained an untrue statement of a material fact or omitted to state a material fact" that was required to be stated or necessary to make the provided statements not misleading (*15 U.S.C. § 77k(a)*). It imposes potential liability on a broad range of actors, including:

- The company itself, which is the issuer of the security.
- Every person who signed the issuer's registration statement.
- Directors of or partners in the issuer at the time the statement was filed.
- The underwriter.
- Accountants and other professionals named as having prepared or certified any part of the registration statement, or any report or valuation used in connection with the registration statement, with respect to the portion the professional purportedly prepared or certified.

(*15 U.S.C. § 77k(a)*.)

Section 12

Section 12 permits buyers of a security to rescind a purchase, or sue for damages if they have already sold the security, under two circumstances.

First, Section 12(a)(1) creates liability for anyone who offers or sells a security in violation of the registration requirements set out in Section 5 of the Security Act (*15 U.S.C. § 77l(a)(1)*).

Liability under this provision covers not only the person who passes title, but also a "statutory seller," or anyone who successfully solicits a purchase "motivated at least in part by a desire to serve his own financial interests or those of the securities owner" (*Pinter v. Dahl, 486 U.S. 622, 646-47 (1988)*; *In re Morgan Stanley, 592 F.3d at 359* (applying the statutory seller definition to claims brought under Section 12(a)(2))). In effect, this section holds underwriters, broker-dealers, selling agents and others directly involved in the selling process potentially liable for any violation of the registration requirements.

Section 12(a)(2) supplements Section 11 by permitting rescission where someone offers or sells a security "by means of a prospectus or oral communication" which contains a material misstatement or omission (*15 U.S.C. § 77l(a)(2)*). Although the statutory language is broad, the Supreme Court has held that this section applies only to public offerings by an issuer itself, and not to private transactions or regular trading (see *Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995)*).

Further, the statute provides that a defendant may avoid liability if the defendant can demonstrate "that he did not know, and in the exercise of reasonable care could not have known" of the alleged untruth or omission (*15 U.S.C. § 77l(a)(2)*).

Defending Section 11 and 12 Claims

Counsel defending Section 11 or 12 claims may consider asserting a series of defenses, including that:

- The plaintiff had knowledge of the untruth or omission at the time the plaintiff purchased the security (*15 U.S.C. § 77k(a)*; *15 U.S.C. § 77l(a)*).
- The defendant's alleged misstatements or omissions did not cause the security's decline in value, which was instead attributable to a general decline in the market (*15 U.S.C. § 77k(e)*; *15 U.S.C. §§ 77l(a),(b)*).
- The non-issuer defendant, after conducting a reasonable investigation, reasonably believed that the registration statement was accurate and complete (known as the due diligence defense) (see *15 U.S.C. §§ 77k(a)(4)-(5), (b)(3)*; *15 U.S.C. § 77l(a)(2)*).

Notably, however, there are several aspects of these rules that may make establishing a Section 11 or 12 claim easier for a plaintiff. For example, a plaintiff does not need to:

- Demonstrate reliance on the defendant's alleged misstatements, unless it is a Section 11 claim and the plaintiff purchased the security after the defendant issued an earnings statement covering a period of at least one year beginning after the effective date of the registration statement (see *15 U.S.C. §77k(a)*).
- Make a showing concerning the defendant's mental state, in contrast to Section 10(b) of the Exchange Act (see below *Scienter*).
- Make a particularized showing of fraud under Federal Rule of Civil Procedure (FRCP) 9(b), unless the plaintiff's claims "sound in fraud" (see *Rombach v. Chang, 355 F.3d 164, 170-71 (2d Cir. 2004)* (fraud is not an element or a requisite to a Securities Act claim)).

SECURITIES AND EXCHANGE ACTS: HISTORICAL BACKDROP

While various states had previously enacted statutes regulating the offer and sale of securities (so-called Blue Sky laws), the Securities Act was the first federal securities legislation. Although all 50 states, the District of Columbia, Guam, Puerto Rico and the Virgin Islands now have their own Blue Sky laws, federal securities laws have largely displaced these statutes.

The Securities Act and the Exchange Act have been periodically amended over the past 80 years, but the framework they impose remains fundamentally unchanged. Rather than creating a system to ensure the soundness of marketed securities, the drafters of the Acts opted for a disclosure-based regulatory framework (see, for example, *Basic Inc. v. Levinson, 485 U.S. 224, 230-31 (1988)*).

President Roosevelt articulated the basic philosophy in remarks to Congress in March 1933. He stated that the federal government "should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained," but it had an obligation to ensure that securities sold in interstate commerce be "accompanied by full publicity and information, and that no essentially important element ... shall be concealed from the buying public." (*President Franklin D. Roosevelt, Message to Congress on Federal Supervision of Investment Securities (Mar. 29, 1933)*.)

Search Liability Provisions: Securities Offerings for more on the due diligence defense and information on other aspects of Section 11 and 12 claims, such as control person liability, fraud under Section 17, and the damages and equitable relief available under the Securities Act.

LIABILITY UNDER SECTION 10(b) OF THE EXCHANGE ACT

While the Securities Act applies to misstatements or omissions in the initial registration and offering of securities, the Exchange Act creates liability for any misstatements or omissions relating to the purchase or sale of securities. It therefore renders any allegedly materially misleading public statement a potential source of liability, including those in SEC filings, on earnings calls or in press releases.

The best-known and most often invoked Exchange Act provision is Section 10(b). This catch-all antifraud provision 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)*).

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 either:

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

(*17 C.F.R. § 240.10b-5*.)

Unlike Sections 11 and 12 of the Securities Act, Section 10(b) of the Exchange Act does not provide for an express private right of action. One has long been implied, however. Courts first found an implied private right of action under Section 10(b) in the mid-1940s, and it was the consensus view by the time the Supreme Court confirmed this approach in *Superintendent of Insurance v. Bankers Life & Casualty Co.* (*404 U.S. 6, 13 n.9 (1971)*; see also *Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2407 (2014)* (citing *Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975)*)).

appropriate scope of liability in light of the broad statutory language and the judicially-created nature of the action.

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 (*Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17* (silence, absent a duty to disclose, is not misleading)).

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 adviser 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." (*Janus, 131 S. Ct. 2296, 2300-2302 (2011)*.)

The Supreme Court has declined to imply a private cause of action for aiding and abetting liability under Section 10(b), in

Not surprisingly, given its broad applicability, Section 10(b) of the Exchange Act provides the most common vehicle for shareholders of a public company to bring securities law claims.

PLEADING REQUIREMENTS UNDER SECTION 10(b)

While Section 10(b) is broader in scope than Section 11 or 12 of the Securities Act, a plaintiff carries a heavier burden in pleading and proving a Section 10(b) claim. Specifically, 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 that is causally connected to the material misrepresentation or omission.

(*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 courts calibrate the

part because the express liability provisions of the Securities and Exchange Acts do not allow for it (see *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 176-77, 179-80, 191 (1994)*). 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)*).

Search Liability Provisions: Securities Offerings for more on the *Janus* decision and its implications.

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. 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. (*Basic Inc., 485 U.S. at 231-32* (quoting *TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)*).)

Materiality generally is 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, for example, *Litwin v. Blackstone Grp., L.P., 634 F.3d 706, 717 (2d Cir. 2011)* (internal quotations 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, for example, *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG, No. 12-4355, 2014 WL 1778041, at *5 (2d Cir. May 6, 2014)*.)

The Supreme Court addressed materiality in *Matrixx Initiatives, Inc. v. Siracusano*. 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." (*131 S. Ct. 1309, 1313 (2011)*.)

The Supreme 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." (*Matrixx, 131 S. Ct. at 1313-14, 1323* (internal quotations omitted).)

Search US Supreme Court Rejects Bright-line Materiality Standard for Section 10(b) and Rule 10b-5 Claims for more on the *Matrixx* decision.

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. (*Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 & n.3 (2007)*; *Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, 214 (1976)*.)

The PSLRA requires a plaintiff also to state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind (see *Tellabs, Inc., 551 U.S. at 321*) (see below *PSLRA*). 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. (See *Tellabs, Inc., 551 U.S. at 323-24*.)

The formulation of the scienter standard adopted by the US Court of Appeals for the Second Circuit is illustrative. Under that standard, a plaintiff may sufficiently plead scienter by alleging facts showing either:

- The defendant had both motive and opportunity to commit fraud.
- Strong circumstantial evidence of conscious misbehavior or recklessness.

(See *Novak v. Kasaks, 216 F.3d 300, 307-308 (2d Cir. 2000)* (noting that 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) (internal quotations omitted).)

For example, courts have found scienter to be insufficiently pled where:

- 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, 200-201 (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 the subsidiary's management (see *Rahman v. Kid Brands, Inc., 736 F.3d 237, 243-44 (3d Cir. 2013)*).

"In Connection With" a Purchase or Sale

Section 10(b) prohibits certain acts "in connection with the purchase or sale of any security" (*15 U.S.C. § 78j(b)*). It is well-settled that a private action under Section 10(b) can be brought only by a buyer or seller of the security. 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)*; *Blue Chip Stamps, 421 U.S. at 730-31, 737-38*).

While the courts have narrowed plaintiff classes to buyers and sellers, in other respects the "in connection with" requirement is read broadly. For example, in *SEC v. Zandford*, the Supreme Court rejected the proposition that the "in connection with" language was limited to violations related to "market integrity or investor understanding" (*535 U.S. 813, 818 (2002)*). Instead, it held that conduct was "in connection with" a securities transaction where a broker "made a series of transactions that enabled him to convert the proceeds of the sales of [his clients'] securities to his own use," regardless of whether his conduct influenced his clients' trading decisions (*Zandford, 535 U.S. at 820-21*).

Recently, courts have focused on the "in connection with" requirement in determining the scope of SLUSA, which precludes certain state law class actions that allege a misrepresentation or an 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*) (see below *SLUSA*).

Reliance

Reliance, sometimes called transaction causation, provides the requisite causal connection between an alleged misstatement or omission and the plaintiff's injury (*Basic Inc., 485 U.S. at 243*).

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 circumstances. In *Affiliated Ute Citizens of Utah v. United States*, 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. (*406 U.S. 128, 153-54 (1972)*.) 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 misstatement or omission.

The most common use of a reliance presumption 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. (*Halliburton, 134 S. Ct. at 2408* (citing *Basic Inc., 485 U.S. at 247*).) This presumption permits class action plaintiffs to avoid individualized issues of reliance when moving to certify a class (see below *Fraud on the Market Presumption*).

Loss Causation

Under Section 10(b), a plaintiff must also 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 (*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, for example, *In re Omnicom Grp., Inc. Sec. Litig., 597 F.3d 501, 511 (2d Cir. 2010)*).

DEFENDING SECTION 10(b) CLAIMS

In addition to challenging a plaintiff's complaint on the required elements of a Section 10(b) claim, a defendant may defend against these claims on the grounds that the plaintiff's claim:

- Involves securities not listed on a US exchange or purchased or sold within the US.
- 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 (*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 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)*).

Search In Dispute: Morrison/National Australia Bank for more on the *Morrison* decision.

Timeliness

A plaintiff's ability to bring claims under Section 10(b) faces two temporal limitations, which must both be satisfied:

- Claims must be brought within two years of "discovery of the facts constituting the violation."
- Claims cannot be brought 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 (*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, 174-75 (2d Cir. 2011)* (a fact is sufficiently discovered when "a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint")).

PRIVATE ENFORCEMENT: THE SHAREHOLDER CLASS ACTION

Not surprisingly, given its broad applicability, Section 10(b) of the Exchange Act provides the most common vehicle for shareholders of a public company to bring securities law claims. In part because of the increase in these securities class actions, and the rise of questionable claims filed with the intent of extracting settlement (known as strike suits), Congress enacted the PSLRA and SLUSA to impose additional requirements for securities class actions that do not apply to other types of class actions.

Additionally, although a securities class action must meet the same certification requirements as any other federal class action and is typically brought under FRCP 23(b)(3), several judicially-created requirements have emerged that afford securities class action plaintiffs favorable presumptions in the class certification process.

Search Class Actions: Overview and Class Actions: Certification for information on federal class actions, including an overview of class action prerequisites and types, and the certification process.

THE POTENTIAL FOR ABUSE

Securities class actions brought under Section 10(b) are often triggered by a drop in a public company's stock price, after which shareholder plaintiffs allege that the negative change in price reflects newly public information that the company previously concealed. A company's changing economic realities may make it vulnerable to these types of allegations, with a potential for very large monetary exposure. This may be true even when the change in stock price results from circumstances beyond the company's control and the underlying misrepresentation claims ultimately are meritless (see *Dura Pharms., 544 U.S. at 342-43* (noting that there may be many reasons why a stock trades at a lower price, other than earlier misrepresentations)).

As the Supreme Court acknowledged almost 40 years ago, "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general" (*Blue Chip Stamps, 421 U.S. at 739-40*). One concern is that even a meritless case has a "settlement value to the plaintiff out of any proportion to its prospect of success at trial" (*Blue Chip Stamps, 421 U.S. at 740*). Not only is defending these types of cases extremely costly, but the mere pendency of the case may impact the company's business. This creates a particular danger of strike suits (see *Halliburton, 134 S. Ct. at 2413*).

Additionally, possible abuse of the liberal discovery rules "may likewise exist in this type of case to a greater extent than ... in other litigation," since these cases often involve depositions of corporate officers and extensive document productions (*Blue Chip Stamps, 421 U.S. at 741*). This concern has heightened resonance, of course, in the age of electronic discovery.

PSLRA

In 1995, after years of fact-finding and debate, Congress passed the PSLRA in response to the increasing number of meritless securities cases brought by plaintiffs' counsel. The statute's purpose was to improve the efficiency of capital markets and foster economic growth by deterring frivolous and burdensome securities litigation suits that were seemingly filed every time an issuer's stock price experienced a significant change. (*Dabit, 547 U.S. at 81* (citing *H.R. Conf. Rep. No. 104-369, at 31 (1995)*).)

The PSLRA amended both the Securities Act and the Exchange Act. It contains a number of procedural reforms for federal securities class actions based on fraud allegations, including, among other things:

- A heightened pleading standard that requires Section 10(b) 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)*; see also *Tellabs, Inc., 551 U.S. at 313-14*; *Dura Pharms., 544 U.S. at 341-42*.)
- A safe harbor for forward-looking statements that were accompanied by meaningful cautionary language or were not knowingly false when made (*15 U.S.C. § 77z-2(c)(1)*; *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. § 77z-1(b)(1)*; *15 U.S.C. § 78u-4(b)(3)(B)*).
- A cap on damages under the Exchange Act 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 the 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. § 77z-1(a)(3)*; *15 U.S.C. § 78u-4(a)(3)*).

Securities class actions brought under Section 10(b) are often triggered by a drop in a public company's stock price, after which shareholder plaintiffs allege that the negative change in price reflects newly public information that the company previously concealed.

BEST PRACTICES FOR DEFENDING SECURITIES CLASS ACTIONS

Because securities class actions pose substantial financial and reputational risk for many public companies, counsel is well advised to take steps early to assess the merits of the case and map out a strong defensive strategy. These steps may include:

- **Moving to dismiss.** The PSLRA successfully raised the pleading standard and courts have not hesitated to dismiss cases if the allegations are inadequate. According to a recent report by National Economics Research Associates on securities cases filed and resolved between 2000 and 2013, courts granted 48% of the motions to dismiss entirely and granted another 25% in part (*NERA, Recent Trends in Securities Class Action Litigation: 2013 Full-Year Review, at 18*, available at *nera.com*).
- **Narrowing the plaintiff class whenever possible.** Certain groups of plaintiffs, for various reasons, may not have standing to bring a claim. For example, a group of plaintiffs might seek to certify a class of plaintiffs who do not meet the domestic transaction requirements established by the *Morrison* decision. Defense counsel should move to exclude these putative plaintiffs from a shareholder class.
- **Evaluating the merits of the case with a critical eye.** Securities class actions rarely go to trial, and the question of settlement is one of risk allocation and timing. From the matter's inception, knowledge of the strengths and weaknesses of the case is critical to these strategic decisions.

Because of the 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.

SLUSA

Despite the explicit intentions behind enacting the PSLRA, securities class action plaintiffs and their counsel began filing cases involving securities traded on national exchanges in state courts, a rare tactic at the time, to avoid the new federal statutory requirements. To curtail this practice and prevent certain state securities class actions alleging fraud from being used to frustrate the objectives of the PSLRA, in 1998, Congress passed SLUSA, which gives federal courts exclusive jurisdiction over certain securities class actions (*SLUSA § 2*).

Specifically, 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 this description is brought in state court, it may be removed to federal court and dismissed on preemption grounds (*15 U.S.C. §§ 77p(b)-(c); 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. § 77p(f)(2); 15 U.S.C. § 78bb(f)(5)*). The three 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 (see *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)*).
- 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 under *Blue Chip Stamps*, resulting in complete preclusion of these class actions in either forum. The PSLRA and SLUSA were motivated by many of the same policy considerations regarding vexatious litigation that anchored the *Blue Chip Stamps* decision, and a narrow reading of the statutes would undercut this purpose. The Supreme Court further reasoned that congressional use of Section 10(b)'s "in connection with the purchase or sale" requirement in SLUSA suggested its intent to give the language its settled judicial interpretation. (*Dabit, 547 U.S. at 85-86.*)

This past term, however, the Supreme Court interpreted SLUSA preemption more narrowly in *Chadbourne & Parke LLP*. Again 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 noncovered 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." (*Chadbourne & Park LLP, 134 S. Ct. at 1065-66.*)

Search Supreme Court Decision Allows More State Law Securities Class Actions for more on the *Chadbourne & Park LLP* decision.

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

JUDICIALLY-CREATED SECURITIES CLASS ACTION REQUIREMENTS

In addition to the unique statutory requirements governing securities fraud class actions, two key judicially-created class certification standards apply only to these types of cases.

Loss Causation Standard

The Supreme Court has held that a plaintiff does not need to prove loss causation to achieve class certification (*Erica P. John Fund, Inc., 131 S. Ct. at 2183*). Reviewing an opinion from the US Court of Appeals for the Fifth Circuit affirming denial of class certification on the grounds that the plaintiffs had failed to establish loss causation, the Supreme Court emphasized the distinction between showing that the deceptive conduct caused the alleged economic loss and establishing that each plaintiff relied on the misstatements and omissions. (*Erica P. John Fund, Inc., 131 S. Ct. at 2184-85*).

Fraud on the Market Presumption

Class certification in a securities class action is often only possible through use of a presumption to satisfy Section 10(b)'s reliance requirement. Unlike loss causation, a presumption of reliance must be established at the certification stage because without it, common questions would likely not predominate (*Halliburton, 134 S. Ct. at 2406*).

Over 25 years ago, the Supreme Court held in *Basic Inc.* that plaintiffs can rely on a "fraud on the market" theory at the certification stage to create a rebuttable presumption of reliance on the alleged misrepresentation (*485 U.S. at 245-50*). This theory posits that in an efficient securities market, any material misinformation will be incorporated into the stock price. A plaintiff who purchases stock at that price, therefore, arguably does so in reliance on the misstatement. In the litigation context, plaintiffs may employ this theory to create a rebuttable presumption that anyone who traded in the defendant's shares during a certain period of time did so in reliance on material misstatements made to the market generally.

To invoke the presumption, the plaintiffs must show that:

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

(*Halliburton, 134 S. Ct. at 2413-14*.)

Recently, in *Halliburton Co. v. Erica P. John Fund, Inc.*, the Supreme Court declined to overrule *Basic*'s fraud on the market presumption (*134 S. Ct. at 2407*). The Supreme Court clarified, however, that defendants must be given the opportunity before class certification to defeat the 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. As a result, defendants can now introduce price impact evidence at the class certification stage (*Halliburton, 134 S. Ct. at 2414*).

Permitting the fraud on the market presumption at the certification stage seems to stand in stark contrast to the "rigorous analysis" that evidence supporting class certification must withstand at the class certification of other class actions (*Wal-mart Stores, Inc. v. Dukes, 131 S. Ct. 2541, 2551 (2011)*). The Supreme Court, however, has reconciled these standards by noting that securities plaintiffs must still satisfy their burden of proving that FRCP 23's requirements are met, which includes establishing the prerequisites for invoking the fraud on the market presumption in the first place (*Halliburton, 134 S. Ct. at 2412*; but see *Halliburton, 134 S. Ct. at 2423* (Thomas, J., concurring in the judgment) ("*Basic* thus exempts Rule 10b-5 plaintiffs from Rule 23's proof requirement")).

Search Expert Q&A on the Fraud on the Market Presumption or see page 18 in this issue for more on the *Halliburton* decision.

Mr. Kasner represented parties in some of the cases cited in this article, including the petitioner, Merrill Lynch, in Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit. *The views expressed in this article are those of the authors and not necessarily those of Skadden, Arps, Slate, Meagher & Flom LLP or its clients.*