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Inside the Courts

An Update From Skadden Securities Litigators

CONTENTS

November 2009 | Issue 5

Skadden

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CONTENTS

November 2009 | Issue 5

ATTORNEY DISQUALIFICATION

Murray v. Metro. Life Ins. Co.,
No. 09-3716-cv
(2d Cir. Sept. 29, 2009)

Click here to view the opinion.

Second Circuit Reverses Attorney Disqualification Order in MetLife Securities Litigation

The U.S. Court of Appeals for the Second Circuit (with Chief Judge Dennis Jacobs writing for the panel) reversed an order disqualifying Debevoise & Plimpton LLP from representing the defendants Metropolitan Life Insurance Co.'s and MetLife, Inc. in a securities litigation brought by Metropolitan Life Insurance Co.'s policyholders concerning its 2000 demutualization. The district court had disqualified Debevoise & Plimpton on the eve of trial, at the plaintiffs' request, because it had represented Metropolitan Life Insurance Co.'s in the demutualization, and therefore represented the policyholders as well. The panel, however, determined that under New York law, Debevoise & Plimpton did not represent the policyholders, even if they were beneficiaries of its advice, because attorneys are counsel to corporations, not their shareholders, and the situation is not different for mutual companies. Further, the panel determined that the witness-advocate rule under New York's Rules of Professional Conduct (which prohibits a lawyer from acting as an advocate in a case where the lawyer is likely to be a witness) did not bar Debevoise & Plimpton's representation because the policyholders did not show by clear and convincing evidence that the four Debevoise & Plimpton lawyers likely to testify would not provide testimony prejudicial to Metropolitan Life Insurance Co. The policyholders sought to call four lawyers to testify; three were corporate attorneys who worked on the demutualization and the fourth, although a member of the trial team, would not be advocating before the jury. The record did not demonstrate that the proposed testimony would be sufficiently prejudicial to warrant disqualifying Debevoise & Plimpton, and — given the nine years of litigation — Metropolitan Life Insurance Co.'s attempt to reverse the disqualification order (including having in-house counsel prosecute the appeal) suggested that the testimony would not be prejudicial. In addition, disqualification would harm the integrity of the judicial process; not only would Metropolitan Life Insurance Co. need new counsel, but the policyholders waited until the eve of trial to propose disqualifying Debevoise & Plimpton, which "has the general tendency to impair rather than promote confidence in the integrity of the judicial system."

AUDITOR LIABILITY

In re Doral Fin. Corp. Sec. Litig.,
No. 08-3867-cv
(2d Cir. Sept. 3, 2009)

Click here to view the opinion.

Second Circuit Affirms Dismissal of 10(b) Violation Claims in Big Four Case

The U.S. Court of Appeals for the Second Circuit affirmed by summary order the district court's dismissal of claims that PricewaterhouseCoopers LLP violated Section 10(b) of the Securities Exchange Act by issuing four audits and one report for Doral Financial Corp. that were materially false, because the complaint did not allege a strong inference of scienter as required by the PSLRA. The panel (composed of Judges Guido Calabresi, José A. Cabranes and Peter W. Hall) explained that, to allege the required strong inference of scienter, the inference must be "cogent and at least as compelling as any opposing inference one could draw from the facts alleged." Further, to constitute reckless conduct, the conduct must be coupled with evidence of corresponding fraudulent intent. The panel also determined that the complaint must show a strong inference of reckless conduct under the PSLRA, even though the Supreme Court held in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal* that a party must only show that the conduct was "plausible" to state a claim. Applying those standards, the panel concluded that the complaint did not allege a strong inference of scienter or reckless conduct, as the opposing inferences — that Doral Financial concealed its fraud from PricewaterhouseCoopers or that PricewaterhouseCoopers was deceived by Doral Financial's internal manipulation of financial results or overriding of internal financial controls — were more compelling than the inference of scienter or recklessness.

CLASS CERTIFICATION

In re Constar Int'l Inc. Sec. Litig., No. 08-2461 (3d Cir. Oct. 29, 2009)

Click here to view the opinion.

Third Circuit Affirms Class Certification in IPO Registration Dispute

In a case alleging violations of Section 11 of the Securities Act, the U.S. Court of Appeals for the Third Circuit (with Judge Marjorie O. Rendell writing for the panel) affirmed the district court's order certifying a class under Rule 23(b)(3). The plaintiffs claimed that Constar International's IPO registration statement misrepresented the strength of its business, and that the truth was disclosed seven months after Constar's IPO. The panel rejected the defendants' principal argument, which asserted that the district court failed to determine if the market for Constar's stock was efficient, a key finding affecting predominance considerations of materiality, loss causation and individualized injury. However, unlike claims brought under Section 10(b) of the Securities Exchange Act, Section 11 claims require only a showing of a material misrepresentation or omission in the registration statement; for that reason, a finding of market efficiency is not necessary to certify a class. Although materiality under Section 11 can be shown the same way as under Section 10(b), it is not required to be, because reliance is not an element of a Section 11 claim. Materiality also can be shown that a reasonable investor would consider the fact to be important and that the effect of the misrepresentation is "felt uniformly" regardless of market efficiency.

Further, loss causation in Section 11 claims is an affirmative defense (the measure of damages is the difference between the price paid for the stock when purchased under the registration statement and its price when the suit was filed or the stock was sold). Consequently, loss and injury are presumed under Section 11 — and any loss is presumed to be caused by correction of the misrepresentation. Even the affirmative defense of loss causation (allowing defendants to show losses were caused by something else) would be an issue common to the class. The panel explained that, notwithstanding a statement that the district court "has adopted a liberal construction of Rule 23," it engaged in the required rigorous analysis to determine that the plaintiffs established the class met the Rule 23 requirements. The Special Master who initially considered the propriety of class certification — then reviewed by the district court — spent 25 pages addressing the required analysis. Additionally, the district court properly stated the parameters of the class and how the Section 11 claims and affirmative defenses could be tried on a classwide basis. The panel also noted that the district court considered the defendants' expert testimony but, because it did not concern Section 11 at all, found it inapplicable to the case.

In re Wells Real Estate Inv. Trust, Inc. Sec. Litig., No. 1:07-CV-862-CAP (N.D. Ga. Sept. 16, 2009)

Click here to view the opinion.

Georgia Federal Court Certifies Class in Alternative Tender Offer Dispute

In a lawsuit alleging violations of Sections 14(a) and 20(a) of the Securities Exchange Act, Judge Charles A. Pannell, Jr. of the U.S. District Court for the Northern District of Georgia certified a class, appointed Washtenaw County Employees' Retirement System (ERS) as the class representative and appointed three firms as class counsel. The class claimed that 12 officers and directors of Wells Real Estate Investment Trust (Wells REIT) and its advisor violated Sections 14(a) and 20(a) of the Securities Exchange Act by failing to disclose the existence of a higher, alternative tender offer in a proxy statement proposing to merge Wells REIT's advisor into it. Before the proxy statement was issued, another company had offered to buy all of the outstanding stock in Wells REIT but cautioned that the price would be lower if Wells REIT's advisor was already merged in.

After determining that the class satisfied Rule 23(a)'s numerosity, typicality and commonality requirements (in part because the defendants did not challenge those requirements), Judge Pannell considered whether ERS would adequately represent the class. The judge declined to follow the Fifth Circuit's ruling in *Berger v. Compaq Computer Corp.* — which held that the PSLRA required a higher adequacy showing at class certification than is required in non-securities cases — and instead concluded that ERS would adequately represent the class, as it

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"has been and continues to be an active participant" in the lawsuit, based on a review of ERS's chairman's entire deposition. In addition, it was immaterial that ERS's counsel knew about the potential of the alternative offer, because the Supreme Court, in *Mills v. Electric Auto-Lite Co.*, held that there is no requirement that the defect in the proxy "actually had a decisive effect on the voting" and because the class' claim was for the failure to disclose that the alternative offer was higher, not just that the alternative offer existed in the first place. Finally, Judge Pannell determined that the class satisfied Rule 23(b)(3)'s predominance and superiority requirements, because "all proposed class members received the same Proxy, thus, the alleged omissions had the same impact" and the alternative — individual suits — would be "repetitive, wasteful, and an extraordinary burden." In addition, the class was certified under Rule 23(b)(2), because injunctive or declaratory relief would be the same for the entire class.

DIRECTORS AND DIRECTORS' DUTIES

Derivative Suits

In re NutriSystem, Inc. Derivative Litig., No. 07-4565 (E.D. Pa. Oct. 26, 2009)

Click here to view the opinion.

Pennsylvania Federal Court Dismisses Derivatives Suit for Failure to Adequately Plead Facts

Judge Mary A. McLaughlin of the U.S. District Court for the Eastern District of Pennsylvania dismissed a derivative suit against NutriSystem's CEO, CFO, CIO, CMO and six outside directors because the complaint failed to adequately plead facts excusing the plaintiff's failure to make a written presuit demand. The case concerned NutriSystem's response to the launch of a competitor entity's product, Alli, a drug that would compete with NutriSystem's products. In this context, the complaint alleged that the defendants made false and misleading statements about the effect of Alli on NutriSystem's business in violation of Section 10(b) of the Securities Exchange Act and engaged in insider trading and improperly authorizing stock buybacks in breach of their fiduciary duties to NutriSystem. Because the complaint challenged both an affirmative decision of the board — to authorize the stock buybacks — and its alleged failure to oversee NutriSystem, Judge McLaughlin applied the tests enunciated by the Delaware Federal Court in *Aronson v. Lewis* (*i.e.*, if the directors exercised their business judgment and if they were disinterested), and in *Rales v. Blasband* (*i.e.*, if the directors were disinterested).

As for the stock buybacks, applying one of the prongs of the *Aronson* test, the court determined that the complaint did not raise a reasonable doubt that the business judgment rule did not cover the board's decision to authorize those buybacks. The complaint did not identify any particularized facts that NutriSystem's stock price was artificially inflated or any statements that "would have inflated" it. Further, the only facts it identified — the progression of FDA approval of Alli and statements made about Alli's potential effect on NutriSystem's business at a NutriSystem-sponsored conference — were public and were part of the total mix of information available to the market.

Further, the court determined that under the other prong of the *Aronson* test and under the *Rales* test, the complaint did not allege sufficient facts to raise a reasonable doubt as to director independence or disinterest. First, the CEO — who was a board member — did not lack independence solely because he received a salary from NutriSystem, because there was no shareholder who could threaten his continued employment. Second, the complaint failed to show a substantial likelihood of director liability for alleged insider trading because there were no specific facts alleged showing that the directors had inside information or that their trading was done in such a way to demonstrate that they had that inside information. Third, the complaint did not allege a substantial risk of director liability from the claims in the complaint. Applying the PSLRA, Judge McLaughlin concluded that the complaint specifically did not identify what statements were allegedly misleading, and those allegedly nondisclosed facts did

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not relate to any of NutriSystem's public statements. In addition, the complaint did not plead adequate facts showing that the directors were responsible for the challenged statements; it was insufficient to allege that the audit committee had "general oversight" over NutriSystem's statements. Further, no strong inference of scienter was alleged, because the information about Alli was all public, and the complaint did not allege any specific red flags ignored by the board. Similarly, the complaint did not allege a substantial likelihood of director liability for breach of their fiduciary duties in connection with a failure to oversee NutriSystem under the Delaware Chancery Court's ruling in *In re Caremark International Inc. Derivative Litigation* (which recognizes that directors' "sustained or systematic" failure to monitor corporate performance can be a breach of their fiduciary duties of loyalty and care).

Mercier v. Blankenship,
No. 2:07-0555
(S.D. W. Va. Sept. 30, 2009)

Click here to view the opinion.

West Virginia Federal Court Dismisses Derivatives Suit Related to Breach of Fiduciary Duty and Executive Compensation Settlement

Judge David A. Faber of the U.S. District Court for the Southern District of West Virginia dismissed a shareholder derivative suit brought on behalf of Massey Energy Co. against Massey's officers and directors (including six outside directors) for breach of their fiduciary duties in connection with Massey's safety and environmental violations, in approving a notice and settlement in another derivative suit (pending in West Virginia state court) and in approving what the complaint alleges to be the CEO's "excessive" compensation, because presuit demand was not excused and would not have been futile under Rule 23.1. The other derivative suit had alleged fiduciary duty claims relating to Massey's safety and environmental violations and the CEO's compensation package.

Judge Faber determined that the settlement in that other derivative suit would be given preclusive effect, because there was no "reason to doubt the quality, extensiveness, or fairness of the *procedures*" in that suit, especially as the plaintiff — who appeared in that suit to object to the settlement — did not avail himself of them (including a right to appeal). Consequently, the plaintiff could not plead demand futility based on allegations released in the settlement of the state court derivative suit. The complaint, therefore, did not plead demand futility as required by Rule 23.1, because it did not allege that there was a substantial likelihood of director liability, that a majority of the board was not independent or that the board's exercise of business judgment was inappropriate. First, a substantial likelihood of director liability was not pled because the post-settlement allegations on the safety and environmental claim were insufficient, the claim relating to the CEO's compensation package had been wholly released by the settlement and settlements — which "almost universally release directors" — are not related-party transactions (thereby precluding liability for breach of the duties of good faith and loyalty) and do not require shareholders to act (thereby precluding liability for breach of the duty of candor). Second, the complaint did not sufficiently allege that a majority of the board was not independent or dominated by the CEO, although it did make particularized allegations that four directors were not independent. Third, the complaint did not plead sufficient facts to show that the directors were not protected by the business judgment rule. The complaint did not plead a substantial risk of director liability for approving the settlement or that the board was not adequately informed before approving the settlement, and how much the CEO was paid is "inherently" a matter of judgment for the board (even if it was "remarkably generous").

Fairness Standard

In re John Q. Hammons Hotels Inc. S'holder Litig.,
No. 758-CC
(Del. Ch. Oct. 2, 2009)

Click here to view the opinion.

Chancery Court Rules Fairness Standard Applies in Merger Dispute

The Delaware Court of Chancery found that *Kahn v. Lynch* did not apply to a merger involving a controlling stockholder where an independent third party made the merger offer to the minority shareholders. However, the court ultimately concluded that the entire fairness standard applied in the facts and circumstances of this case due to procedural deficiencies in the sale

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process and vote. John Q. Hammons Hotels, Inc. (JQH) was controlled by John Q. Hammons, who owned five percent of Class A common stock and all of Class B common stock, totaling 76 percent of the total vote in JQH. In 2004, the JQH board formed a special committee to evaluate and negotiate proposed transactions. In 2005, the special committee received an offer from unaffiliated third party Jonathan Eilian, and ultimately, the JQH board voted to approve a merger with an acquisition vehicle owned by Eilian in which JQH's Class A minority stockholders received $24 cash per JQH share, and Hammons, the only holder of Class B stock, received an equity interest in the surviving limited partnership, a preferred interest with a large liquidation preference and other contractual rights. The merger was conditioned on approval by a majority of unaffiliated Class A stockholders voting on the transaction, which condition the special committee could waive. Hammons and the newly formed acquisition entity also entered into a series of complex agreements to provide Hammons financing to continue developing hotels without triggering certain tax liabilities. Plaintiff minority stockholders sued, arguing (1) that Hammons breached his fiduciary duty as controlling stockholder by negotiating benefits for himself that the minority stockholders did not receive; (2) that the JQH directors breached their fiduciary duties by allowing a deficient merger negotiation process and approving the merger; (3) that the acquisition vehicles aided and abetted the breaches of fiduciary duty; and (4) that JQH's proxy statement contained misstatements and omissions regarding the special committee process and potential advisor conflicts. Both plaintiff and defendants moved for summary judgment.

In evaluating the merger, the court found that *Kahn v. Lynch* did not mandate that entire fairness standard of review applied. The court found that because Hammons did not stand on both sides of the transaction, *Lynch* "does not mandate that the entire fairness standard of review apply notwithstanding any procedural protections that were used." The court pointed out that, unlike *Lynch*, "the controlling stockholder in this case did not make the offer to the minority stockholders; an unrelated third party did." The court therefore held that, "[i]n this case — which, again, I have determined is not governed by *Lynch* — business judgment would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent special committee, *and* (2) approved by stockholders in a nonwaivable vote of the majority of all the minority stockholders."

The court found, however, that in this case, the minority stockholder vote was insufficient to invoke the protections of the business judgment rule. The court found that the entire fairness standard of review ultimately applied, but not because it was mandated by *Lynch*; "[r]ather, it results from deficiencies in the specific procedures used in this case." Here, only a majority of the minority stockholders voting on the matter had to approve the merger, not a majority of *all* the minority stockholders, and the special committee could have waived the vote. The court concluded, "[t]he majority of the minority vote ... provides the stockholders an important opportunity to approve or disapprove of the work of the special committee and to stop a transaction they believe is not in their best interests. Thus, to provide sufficient protection to the minority stockholders, the majority of the minority vote must be nonwaivable, even by the special committee." Applying the entire fairness standard of review, the court found that factual and legal disputes regarding the persuasive value of the special committee's advisor's opinion on the issue of fair price precluded summary judgment in favor of the defendants on the issue of fair price. As to fair dealing, the court found that there was not evidence that Hammons coerced the special committee. However, on a summary judgment motion, the court could not resolve the issue of whether Hammons' alleged self-dealing depressed the value of the minority shares, and "the issues of whether the price of the minority shares was depressed as a result of such conduct, and whether, as a result, the special committee or the minority stockholders were improperly coerced into accepting the Merger, must remain for trial."

On the disclosure claims, the court found that defendants were entitled to summary judgment on the claims surrounding the special committee process because directors are not required to

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disclose the plaintiffs' characterization of the facts surrounding the special committee process or engage in "self-flagellation." However, the court found that the special committee should have disclosed potential conflicts of its investment advisors, and defendants were not entitled to summary judgment on that claim. The court also permitted other disclosure claims to move forward to trial.

The court also refused to dismiss the aiding and abetting claims against Eilian, finding "there remains a material issue of fact as to whether Eilian was aware that JQH's stock price was depressed as a result of Hammons's improper self-dealing conduct." For those reasons, the court granted defendants' motions for summary judgment in part and denied in part, and also granted plaintiffs' motion for partial summary judgment in part and denied in part. The court ruled that the parties should proceed to trial on most of the claims, but, importantly, left open the possibility that defendants could shift the burden of proving entire fairness to the plaintiffs if defendants could show that the special committee process was sufficient.

Fiduciary Duties

Baldwin v. Bader, Nos. 08-2588, 09-1017 (1st Cir. Oct. 19, 2009)

Click here to view the opinion.

First Circuit Affirms Mixed Liability Ruling in Fair Valuation Case

In a suit brought by a shareholder of a private company against the board of directors over two board decisions to issue additional stock to stockholders who personally guaranteed loans to the company, the U.S. Court of Appeals for the First Circuit (with Judge Michael Boudin writing for the panel) affirmed the district court's ruling that the directors were not liable to the plaintiff for the first transaction but were liable to the plaintiff for the second. The plaintiff was offered the opportunity to participate in both transactions but declined to participate in either one, and he thereby suffered a dilution of his holdings.

Applying Delaware law — because the company was incorporated in Delaware — the panel explained that, in approving these transactions, the board had a duty of care to seek a fair valuation of the company and to avoid overpaying and "unnecessarily" diluting other shareholders' holdings. In the first instance, the plaintiff had to show that the board was careless; if he did so, the board could avoid liability if it showed the transaction was fair. The first transaction was made when the company was in "serious trouble," and so it was proper to provide an incentive for individual shareholders through the award of more shares to make the necessary personal guaranties. The board calculated the formula for awarding additional stock based upon aborted negotiations with another company and was (as the board conceded) "the only number that all guarantors could agree upon." Although the board could have hired a valuation consultant, the panel recognized that "time was of the essence" and consultants cost money, which the company did not have. Further, the board offered the formula when it appeared that the potential new creditor would require all shareholders to make a personal guarantee (thereby avoiding any dilution), even though the stock was not issued until later.

As for the second transaction, the company was in better shape, and the panel determined that the directors breached their duty of care by applying the same formula as in the first transaction. The panel explained that judging the fairness of the transaction under Delaware law is done is by considering both the price of the transaction and nonprice considerations, which taken together could better show fairness than when considered separately. However, the panel still noted that there was little evidence that the price was fair, because, among other things, a valuation report had been written between the two transactions, which estimated that the company was worth more than it had been at the time of the first transaction. Moreover, the nonprice considerations the board pointed to (the company's need for additional financing, reliance on an already developed formula, the plaintiff's ability to participate if he chose and advice of counsel) did not provide nonprice support that the transaction was fair. The company was in better shape, so there was no urgency to rely on the unsupported formula

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previously used and any breach was not excused simply because the directors made the offer to all shareholders (Delaware law does not vindicate self-interested decisions just because the opportunity is provided to all). Further, the panel explained that even if reliance on counsel can evidence "good faith and the overall fairness of the process," it is not a dominant consideration, and there was no evidence that counsel actually advised the board to apply the formula in the second transaction.

In re NYMEX S'holder Litig., Nos. 3621-VCN, 3835-VCN (Del. Ch. Sept. 30, 2009)

Click here to view the opinion.

Chancery Court Dismisses Two Actions Related to $10 Billion Acquisition of NYMEX

The Delaware Court of Chancery dismissed two actions — *In re NYMEX Shareholder Litigation* and *Greene v. New York Mercantile Exchange, Inc. et al* — challenging the now-consummated $10 billion acquisition of NYMEX Holdings, Inc (NYMEX) and CME Group, Inc. (CME). Collectively, these cases raised a multitude of fiduciary, corporate governance and contractual claims. All claims were dismissed in their entirety for failure to state a claim.

In the first action, former NYMEX shareholders alleged that the NYMEX directors breached their fiduciary duties of loyalty, due care and candor in regard to the sale of NYMEX to CME, and that CME aided and abetted those breaches. Specifically, the former NYMEX shareholders argued, among other things, that the NYMEX directors breached their fiduciary duties by allowing allegedly controlling and conflicting management to conduct a flawed sales process, failing to bargain for a collar and omitting material information from the proxy statement. They argued that the various fiduciary failures by the NYMEX directors resulted in an unfair price obtained through an unfair process. The court disagreed. Relying on the recent Delaware Supreme Court decision in *Lyondell Chemical Co. v. Ryan*, the court held that NYMEX's exculpatory clause in its charter protected the NYMEX directors from monetary damages stemming from the breaches of the duty of care, and that it would be unreasonable to infer from the plaintiffs' allegations that the board acted in any way disloyally or in bad faith. The court found that the NYMEX board was "clearly independent," and that "[i]t is well within the business judgment of the Board to determine how merger negotiations will be conducted," which included the decision to have management conduct the negotiations and to not bargain for a collar. The court also dismissed the claim that management failed to disclose and pursue a supposedly higher bid from another suitor on the grounds that such claim was derivative and plaintiffs lost standing to bring such a claim following the merger. Finally, the court also dismissed all of the plaintiffs' disclosure claims on the grounds that none of these claims sounded in disloyalty or bad faith. Claims against CME for aiding and abetting breaches of fiduciary duty were dismissed on the grounds that they were conclusory in nature.

In the other action, brought by Class A Members of the NYMEX, claims were raised challenging the specific terms of the deal that Class A Members received in the transaction. Like the NYMEX stockholders, the Class A Members brought similar fiduciary duty claims and also alleged that the NYMEX board inadequately compensated the Class A Members for their loss of certain rights and privileges as a result of the transaction. In dismissing the case, the court determined an issue of first impression — whether the Class A Members, who no longer held an equity stake in NYMEX after the exchange's demutualization, were even owed fiduciary duties. The court concluded that the NYMEX directors owed no fiduciary duties to the Class A Members solely by virtue of their membership and that any rights the Class A Members had were purely contractual, and limited by the specific terms of the exchange's charter and bylaws. The court then dismissed all of the Class A Members' fiduciary duty claims and found that their contractual claims (based on certain rights specified in the bylaws) were extinguished by the Class A Member vote to amend the bylaws (which occurred at the time of the stockholder vote to approve the transaction).

For all of these reasons, the court granted the defendants' motions to dismiss, and dismissed both actions in their entirety. In dismissing these cases, the court commented that "one cannot

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help but wonder if the Plaintiffs in both actions have sought to present a litany of claims with the hope that in the aggregate they will support a theme that something untoward occurred. In this instance, the court is not persuaded that it can reasonably infer that the collective whole is greater than the sum of the individual parts."

Securities Fraud Pleading Standards

Collins & Aikman Corp. v. Stockman, No. 07-265-SLR-LPS (D. Del. Sept. 30, 2009)

Click here or here to view the opinions.

Delaware Federal Court Dismisses Multiple Claims Against Bankrupt Company's Former Officers, Directors, Stock Owners and Auditors

In a lawsuit brought by the liquidation trustee of Collins & Aikman Corp.'s (C&A) Chapter 11 bankruptcy estate against its officers, directors, plurality stock owner (Heartland Industrial Partners) and outside auditors, Judge Sue L. Robinson of the U.S. District Court for the District of Delaware adopted Magistrate Judge Leonard P. Stark's May 20, 2009, recommendation regarding the plaintiff's claims for violations of Section 10(b) of the Securities Exchange Act, common law fraud, breach of fiduciary duty, unjust enrichment and breach of contract. The liquidation trustee alleged that C&A's officers, directors, accountants and private equity owner engaged in accounting fraud to "artificially inflate" its financial results, enabling it to borrow more money and ultimately resulting in C&A's Chapter 11 bankruptcy, *i.e.*, a "deepening insolvency" theory.

The court declined to dismiss claims against three officers and one outside director for violation of Section 10(b) of the Securities Exchange Act, but dismissed common law fraud claims against four officers (including the three accused of violating Section 10(b)) and an outside director for the same conduct. Deepening insolvency can be the harm underlying a Section 10(b) claim and is sufficient to plead loss causation. Further, C&A could state a Section 10(b) claim against its directors for withholding "key information," although similar fraud claims were barred by Delaware law because a corporation cannot be defrauded by its directors. Scienter was alleged because those officers and the outside director participated in specific fraudulent transactions, drafted materials for C&A to take on additional debt and signed incorrect public filings.

Further, the court dismissed breach of fiduciary duty *Caremark* claims against two officers (because those claims cannot be brought against officers), five outside directors (because the complaint did not allege a lack of internal controls or that the directors ignored red flags caused by inadequate controls), and Heartland Industrial Partners (because it was not alleged to be a majority shareholder or that it had actual control over C&A, even though it had the right to nominate a majority of the board). The court, however, declined to dismiss those claims — for breach of care and loyalty — against four other officers and one other outside director, because it was alleged how they "failed to act in a sufficiently careful and informed matter" by engaging in the accounting fraud and were not barred by C&A's exculpatory provision for breaches of the duty of care alone. The court dismissed the unjust enrichment claims against one officer and Heartland Industrial Partners (because the payments to them were made under a valid, legally enforceable contract) and against five other officers and four outside directors (because there were no specific factual allegations about how payments to them "impoverished" C&A). However, the court declined to dismiss those claims against two outside directors (because both received funds through "an 'acquisition spree' which 'positioned the Company for disaster'" and because one had entered into an unnecessary noncompetition agreement with C&A). Further, the court dismissed the breach of contract claims against Heartland Industrial Partners, because nothing in its contract with C&A required it to give accounting advice, and the liquidation trust was unable to identify which provision was violated. Finally, Judge Robinson declined to adopt Magistrate Judge Stark's recommendation that the professional negligence/malpractice claims against C&A's auditors be dismissed, because the complaint was "replete" with allegations about red flags that the auditors should have responded to, and remanded those claims for further review.

In re Schering-Plough Corp. / ENHANCE Sec. Litig., No. 08-CV-397 (DMC) (D.N.J. Aug. 31, 2009)

Click here to view the opinion.

New Jersey Federal Court Denies Motion to Dismiss in Claims Involving Drug's Clinical Trials

Applying the Supreme Court's decision in *Ashcroft v. Iqbal*, Judge Dennis M. Cavanaugh of the U.S. District Court for the District of New Jersey denied a motion to dismiss claims alleging that Schering-Plough Corp., five members of its senior management, 11 current directors, one former director and 18 underwriters for Schering-Plough's public stock offering violated Sections 11, 12(a)(2) and 15 of the Securities Act, and Sections 10(b), 20(a) and 20A of the Securities Exchange Act because the complaint adequately alleged all of the elements of the claims. The complaint alleged that the defendants made material misstatements about the drug Vytorin and an associated clinical study. The court determined that the complaint adequately pled the existence of actionable misstatements and omissions (*e.g.*, the efficacy of Vytorin, the clinical study and Schering-Plough's financial outlook) which, as required by the PSLRA's heightened pleading requirements, were described with adequate particularity as to "who, what, when, where and how" for each statement. The complaint also alleged sufficient facts to create a strong inference of scienter (including fact-specific allegations about advance knowledge of the clinical study results and attempts to conceal those results), which were at least as compelling as to suggest that the defendants were not acting with scienter.

Consequently, Judge Cavanaugh declined to dismiss the Section 10(b) claims. Because the Section 10(b) claim was adequately pled and the complaint additionally adequately pled that four individuals exercised control over Schering-Plough based on their positions and involvement in its public statements, the judge declined to dismiss the Section 20(a) claims against those individuals. In addition, the complaint adequately pled Section 20A claims against one individual defendant and Schering-Plough, because the Sections 10(b) and 20(a) claims were adequately pled and the complaint additionally pled with particularity that the individual sold stock while possessing material, nonpublic information about the study results which Schering-Plough had communicated to him and other executives without disclosing the information to investors.

Judge Cavanaugh also declined to dismiss the Securities Act claims because those claims were expressly pled in negligence, not fraud, and therefore were not subject to Rule 9(b)'s heightened pleading requirements. Because the complaint identified material misstatements under Sections 11 and 12(a)(2) (*e.g.*, that defendants failed to disclose negative results from the clinical study in the offering documents) and alleged with supporting details that one of the plaintiffs had purchased shares "pursuant and/or traceable to" Schering-Plough's common stock offering, Judge Cavanaugh declined to dismiss the Section 11 and 12(a)(2) claims. Because those claims were adequately alleged, the judge also declined to dismiss the Section 15 claim against four individual defendants, as the complaint adequately alleged that those four defendants "actually controlled Schering and participated in its violations of the Securities Act."

Shareholder Inspection Rights

City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc., No. 4473-VCN (Del. Ch. Sept. 28, 2009)

Click here to view the opinion.

Chancery Court Rejects Shareholder Demand to Inspect Company's Books

Plaintiff, a shareholder in Axcelis Technologies, Inc., brought an action in the Delaware Court of Chancery pursuant to 8 *Del. C.* § 220 to inspect the books and records of the company. The plaintiff argued that two actions, taken together, were evidence of wrongdoing by the board of directors that gave plaintiff a proper purpose for inspecting the company's books and records. First, Axcelis, which used plurality voting for director elections, had a "Pfizer" policy in place (Policy) requiring a director standing for reelection who received less than a majority stockholder vote to submit his or her resignation to the board, which then had the discretion to accept or reject the resignation. At the 2008 annual meeting, three directors did not receive a majority vote and submitted their resignations, which the board refused to accept. Second, the plaintiff challenged the board's actions regarding acquisition offers by competitor SHI. The Axcelis board first rejected two unsolicited offers from SHI to acquire Axcelis, and later agreed to sell

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its principal asset to SHI for significantly less than SHI's original offer price. The plaintiff argued these board actions were evidence of wrongdoing that entitled it to inspect Axcelis' books and records. The court rejected this contention, and found that the plaintiff had no proper purpose for inspection.

First, the court found that the plaintiff had no credible basis for challenging the board's decision to retain the three directors, and that the record did not support plaintiff's argument that the board's decision was either motivated by entrenchment or was defensive in nature. The court held that "[o]nly the Plaintiff's bare accusations suggest [an entrenchment] motive, and mere accusations are insufficient." The court further explained that the company's policy regarding board resignation gave the board discretion to accept or reject the directors' resignations, and that "[b]y refusing to accept these resignations, the Board effectuated the results of a valid shareholder election. There is no evidence that the Board identified, and then sought to thwart, the will of the shareholder franchise by refusing to accept the resignations of the Three Directors." Furthermore, the court found that board's exercise of its discretion did not warrant heightened scrutiny, because applying a heightened form of scrutiny "would require this Court to accept the theory that mere shareholder reliance upon a board-enacted governance policy could effectively rewrite the [plurality] voting provisions contained in a corporation's by-laws." The court also refused to find that, by itself, acting in accordance with the Policy was credible evidence of wrongdoing, noting that "[i]f mere acting in accordance with the terms of a Pfizer-style policy is found credible evidence of wrongdoing, then its death knell has been rung…. Merely pointing out the Board's exercise of discretion under the Policy — an exercise which ultimately effectuated the shareholder franchise — is not credible evidence of wrongdoing on this record."

Second, the court found that there was no credible basis to infer any wrongdoing by the board in negotiating with SHI. The court noted, "[f]ailed negotiations, without more, do not form a credible basis supporting an inference of wrongdoing."

Ultimately, the court found that this left plaintiff's only remaining purpose for inspecting the books and records to discover how the company's stock price dropped so dramatically. However, "the Plaintiff must point the court to something other than a precipitous drop in stock price before Section 220 inspection rights may be granted. Otherwise, Delaware corporations would be universally subject to the very burdens Section 220 was carefully designed to protect against." The court dismissed the action and entered judgment in favor of the company, holding a shareholder's right to inspect books and records "is not unlimited."

DISCOVERY

Sec. & Exch. Comm'n v. Strauss, No. 09 Civ. 4150 (RMB) (HBP) (S.D.N.Y. Oct. 28, 2009)

Click here to view the opinion.

S.D.N.Y. Denies Application to Access SEC Summary Notes of FBI Witness Interviews

Magistrate Judge Henry Pitman of the U.S. District Court for the Southern District of New York denied a defendant's application to compel the SEC to provide him with its summary notes of FBI-directed witness interviews and access to an electronic database for which the SEC had access through an investigative subpoena. The SEC's notes — some by attorneys and some by nonattorneys, at attorney direction — were protected from disclosure by the work product protection. Although the defendant attempted to characterize the summary notes as verbatim copies of the FBI's interview notes, Magistrate Judge Pitman noted that summaries are not the same as verbatim copies. Because the defendant had not attempted to seek the FBI's own interview notes, it suggested that the defendant was more interested in the SEC's analysis of the statements than in the statements themselves. Further, the defendant had not shown a substantial need for the SEC's summary notes. Additionally, although the electronic database was not subject to the attorney work product protection (allowing the defendant to observe what files the SEC had open and for how long, an effect of the database configuration, would

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not disclose attorney theories), the court determined that the defendant could easily obtain access to the database through a subpoena on the third-party host (as the SEC had done). The SEC had paid for the right to access the database for four users. Under Rule 26(b)(2)(C)(i), it would be burdensome to force the SEC to give the defendant access to the database through the SEC's access. Only four users were able to access the database at the SEC, and if one of those were the defendant, it would impede the SEC's ability to prepare because fewer employees could access the database at a time. The fact that only one user could access a database document at a time meant that the defendant would be able to potentially interfere with the SEC's ability to use the database during discovery. Finally, ordering the SEC to provide the defendant with access would create potential precedent in similar situations, and the defendant had not shown that there were any financial obstacles to his purchasing access to the database.

ERISA

In re Citigroup ERISA Litig., No. 07 Civ. 9790 (S.D.N.Y. Aug. 31, 2009)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims in ERISA Litigation Related to Subprime Mortgage Exposure

On a motion to dismiss, Judge Sidney H. Stein of the U.S. District Court for the Southern District of New York dismissed putative class claims that Citigroup Inc., former CEO Charles Prince, former Chairman Robert Rubin and the committees overseeing Citigroup's two ERISA-qualified 401(k) plans breached the fiduciary duties owed to the plan participants by failing to disclose the extent of Citigroup's exposure to subprime mortgages and failing to cease offering participants the ability to invest in Citigroup stock.

The court held that, under the Third Circuit's rulings in *Edgar v. Avaya, Inc.*, the committee administering the plan were "'immune from judicial inquiry'" because the terms of the 401(k) plans unambiguously obligated them to offer Citigroup stock as an investment option, prohibited them from liquidating the Citigroup stock fund and could not override the plans' terms (without amending the plans, which ERISA prohibited them from doing). Similarly, because the complaint only alleged that Citigroup had the authority to hire or fire some of the fiduciaries, and failed to allege how Citigroup used that authority to exert control of those fiduciaries, the complaint did not allege a plausible claim (under *Twombly* and *Iqbal*) that Citigroup — as the plans' sponsor — was a de facto fiduciary of the plans. Similarly, Judge Stein decided to join six other courts which, after *Twombly*, applied the presumption set forth the by the Third Circuit in *Moench v. Robertson*, that it is consistent with ERISA for plan fiduciaries to invest in the employer stock, and held that the plaintiff did not rebut that presumption, because Citigroup's allegedly "imprudent and risky business strategies" (resulting in a 52 percent decline in stock price) did not "suggest 'the type of dire situation'" that was significant enough to make the defendants believe there was a threat to Citigroup's viability. Consequently, the court also rejected a claim that the defendants failed to investigate. Judge Stein also concluded that, even though a plan fiduciary must disclose information about benefits, ERISA does not require plan fiduciaries to disclose financial information about companies that participants invest in, and if they volunteer information it must be when acting in a fiduciary or ERISA capacity to be actionable as an ERISA violation. Therefore, because Prince and Citigroup were not designated by the plans as individuals able to act in a fiduciary or ERISA capacity (the plans designated the administrative committee instead), they did not have a duty to disclose Citigroup's financial information or to avoid making untrue statements about its financial condition.

Moreover, the complaint did not allege facts that the committee administering the plans knew or should have known about Citigroup's subprime mortgage exposure; the sole allegation to the contrary was simply a "naked assertion" without any underlying facts. Judge Stein also dismissed claims that Citigroup, Prince and Ruben failed to monitor the plan fiduciaries (because there was nothing to monitor if the committee they were supposed to monitor could not have eliminated investments in Citigroup stock) and that they failed to disclose information to co-

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fiduciaries (because such a duty would extend their responsibilities beyond what was outlined by the plans). Finally, because the complaint alleged only that the defendants' compensation was tied to Citigroup's stock performance, the court dismissed claims that all of the defendants had conflicts of interest because those allegations were insufficient to plead actionable conflict of interest.

LEAVE TO AMEND

Fannon v. Guidant Corp.,
No. 08-2429
(7th Cir. Oct. 21, 2009)

Click here to view the opinion.

Seventh Circuit Refuses to Give Plaintiffs Another Opportunity to Attempt to Plead Scienter

The U.S. Court of Appeals for the Seventh Circuit, in an opinion authored by Judge Diane P. Wood, affirmed the district court's refusal to provide plaintiffs with any additional opportunity to cure the shortcomings in their complaint alleging securities fraud, despite it being only their *first* consolidated complaint. To this end, the Seventh Circuit affirmed the district court's (1) dismissal of plaintiffs' first consolidated securities action complaint with prejudice for failing to raise the strong inference of scienter required by PSLRA; (2) denial of plaintiffs' motion for leave to amend; and (3) denial of plaintiffs' motion under Rule 59(e) to reconsider the dismissal. While noting that "there are some cases in which courts of appeals have found that it is best to use a dismissal without prejudice for a PSLRA complaint" and acknowledging that this was only the plaintiffs' first consolidated complaint, the Seventh Circuit held that the district court did not abuse its discretion in dismissing the complaint with prejudice because plaintiffs "had, as a practical matter, a number of opportunities to craft a complaint that complied with the standards of the PSLRA." Central to its affirmance of the district court's decision to dismiss with prejudice, the Seventh Circuit noted that plaintiffs (1) had about a year to review and investigate the case before filing the consolidated complaint; (2) were permitted to, and did, correct the first consolidated complaint; and (3) did not amend their complaint before dismissal, despite twice notifying the court about additional information that they had acquired. Next, the court affirmed the district court's denial of plaintiffs' motion for leave to amend because, once a judgment is entered, plaintiffs' proper course is to move for reconsideration, not for leave to amend. Finally, as to plaintiffs' motion for reconsideration, the court also held that it was not an abuse of discretion to deny the motion for reconsideration because plaintiffs both failed to identify how its purportedly "new" evidence would address the deficiencies of the first complaint and failed to explain why the evidence was not presented prior to the court's decision on the motion to dismiss.

LOSS CAUSATION

Barrie v. InterVoice-Brite, Inc.,
No. 3:01-CV-1071-K
(N.D. Tex. Oct. 26, 2009)

Click here to view the opinion.

Texas District Court Denies Class Certification in Light of Fifth Circuit Precedent Requiring Loss Causation at Certification Stage

Judge Ed Kinkeade of the U.S. District Court for the Northern District of Texas denied plaintiffs' class certification motion because plaintiffs failed to prove loss causation in accordance with the Fifth Circuit's decision in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.* and its progeny. In the underlying action, plaintiffs alleged that Intervoice-Brite and a number of its executives (collectively, IVB) violated Sections 10(b) and 20(a) of the Securities Exchange Act by, among other things, making false statements about (1) the benefits of the merger between Inter Voice Response Systems (IVR) and Brite, which created IVB; (2) IVB's earnings forecasts; and (3) IVB's revenue recognition procedures. IVB argued that plaintiffs could not benefit from the fraud-on-the-market presumption at the class certification stage because they failed to show that the alleged misstatements caused the price decline at issue — a 55 percent one-day

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decline in share price following IVB's June 6, 2000, issuance of a press release that stated that IVB had been impacted by sales staff attrition and was forecasting only $67 million-68 million (instead of $89 million) in revenues for the first quarter of 2001 (the Press Release). Judge Kinkeade previously granted plaintiffs' motion for class certification; however, that decision was reversed by the Fifth Circuit in light of its decision in *Oscar*, which held that plaintiffs must prove loss causation at the class certification stage.

Back from appeal, the district court reiterated that the Fifth Circuit, in *Oscar*, "'tighten[ed]' the requirements for plaintiffs seeking a presumption of reliance'" and "'essentially ... require[s] plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption.'" To prove loss causation, plaintiffs have two choices: They can either show that mistruths increased share price or show that a corrective disclosure caused a decrease in share price by exposing the mistruths. In the case at bar, plaintiffs' experts were unable to show any "statistically significant stock price increases following any of the alleged statements" and, thus, could only proceed on the theory that the Press Release allegedly corrected the earlier misstatements and omissions. To prevail on such a theory of loss causation, the Fifth Circuit requires that plaintiffs show that "1) the negative 'truthful' information causing the decrease in price is related to an allegedly false, non-confirmatory positive statement made earlier; and 2) that it is more probable than not that it was *this* negative statement, and not other *unrelated* negative statements, that caused a significant amount of the decline."

Judge Kinkeade found that plaintiffs could not make the requisite showing. First, as to the allegedly false revenue forecasts, plaintiffs submitted no evidence that the alleged misrepresentations were actually made and, as a result, they could not provide a basis to prove loss causation. Second, as to alleged misstatements about the merger, the court found that plaintiffs failed to "meet the relatedness test imposed by *Oscar*" because the Press Release attributed the first quarter 2001 earnings miss to attrition in IVB's sales force, not the progress of the merger. Finally, plaintiffs' alleged misstatements about IVB's revenue recognition procedures could not support a finding of loss causation because, according to plaintiffs' own allegations, they were not disclosed to the market until weeks after the Press Release and, upon disclosure, did not cause a drop in share price. Because plaintiffs failed to establish loss causation by a preponderance of the evidence for any of the alleged misstatements, they could not satisfy Federal Rule of Civil Procedure 23(b)'s predominance requirement for class actions.

McAdams v. McCord,
No. 09-1303
(8th Cir. Oct. 20, 2009)

Click here to view the opinion.

Eighth Circuit Affirms Dismissal for Failure to Plead Loss Causation

The U.S. Court of Appeals for the Eighth Circuit, in an opinion authored by Judge Duane Benton, affirmed the dismissal of a federal securities fraud action for failure to plead loss causation in accordance with *Dura Pharmaceuticals, Inc. v. Broudo*. The complaint alleged, among other things, that Moore Stephens Frost, PLC (MCF) — the outside auditor for UCAP, Inc., a multistate provider of mortgage lending and brokerage services — violated Section 10(b) and Rule 10b-5 of the Securities Exchange Act. The complaint contained numerous allegedly fraudulent statements by UCAP's executives, which MSF allegedly assisted them in making by distorting the financial condition of the company. The complaint also contained some purportedly false and misleading statements attributable to MSF. The district court granted MSF's motion to dismiss the complaint for failure to meet the heightened pleading standards of the PSLRA and Rule 9 of the Federal Rules of Civil Procedure, and the Eighth Circuit affirmed, albeit on different grounds.

The Eighth Circuit first observed that MCF could only theoretically be found liable for the two statements that it purportedly made, not for "assist[ing] the executives" by distorting UCAP's financial condition. As the court explained, Section 10(b) does not impose liability on a person "who aids in making the misstatement or omission." Nor could plaintiffs base a Section 10(b) claim on the two statements attributable to MCF because plaintiffs failed to plead loss causation with sufficient particularity. Plaintiffs' allegation of loss causation — which consisted only

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of a "threadbare, conclusory statement" that their losses were caused by MCF's misrepresentations and omissions — was insufficient. Fatal to its claim, the allegation did not specify how "statements by MSF, as compared to the complaint's long list of alleged misrepresentations and omissions by the [UCAP] executives, proximately caused the investors' losses." Equally insufficient was plaintiffs' allegation that they purchased the securities at "artificially inflated prices." As the Eight Circuit explained, "subsequent loss in value can reflect a variety of factors other than" the defendants' alleged misconduct. The complaint also failed to state the price at which plaintiffs purchased their shares, as well as the price before and after UCAP's restatement. In sum, the court concluded that "[w]ithout these facts, the complaint does not show that the investors' losses were caused by MSF's misstatements."

MATERIALITY

Siracusano v. Matrixx Initiatives, Inc., No. 06-15677 (9th Cir. Oct. 28, 2009)

Click here to view the opinion.

Ninth Circuit Rejects 'Statistical Significance' Test in Reversing Dismissal of Matrixx Securities Action

The U.S. Court of Appeals for the Ninth Circuit, in an opinion authored by Judge A. Wallace Tashima, reversed the district court's dismissal of a putative securities fraud class action against pharmaceutical company Matrixx and three of its executives (collectively, Matrixx) stemming from an alleged decline in its share price following reports that Matrixx's main product, Zicam, was possibly linked to anosmia (the loss of smell). In so doing, the Ninth Circuit rejected the district court's application of the "statistically significant" test, by which an alleged omission is deemed material only if the number of complaints about the drug is "statistically significant." In the underlying action, plaintiffs alleged that Matrixx violated Section 10(b) and Rule 10b-5 of the Securities Exchange Act by failing to disclose information regarding the possible link between Zicam and anosmia. According to the complaint, Matrixx knew of Zicam's potential for causing anosmia based on, among other things, reports from doctors that patients developed ansomia after Zicam use, studies linking Zicam's active ingredient to anosmia, and individual lawsuits alleging Zicam caused anosmia. Meanwhile, Matrixx allegedly issued a 10-Q that allegedly failed to disclose potential liability from Zicam as a risk factor, a Form 8-K asserting Zicam's efficacy and safety, along with press releases stating that Matrixx's financial future was strong, Zicam's efficacy had been "well established," and contrary allegations were "unfounded." The district court — applying the "statistical significance" standard used by the Second Circuit — dismissed the action because the number of complaints that Zicam caused anosmia were statistically insignificant. Additionally, the district court found that the plaintiffs failed to plead scienter sufficiently. The Ninth Circuit reversed on both points and remanded the case for further proceedings consistent with its decision.

Central to its reversal, the Ninth Circuit found that the district court improperly used the "statistical significance" test as a "bright-line" substitute for the "fact-specific" materiality analysis mandated by *Basic Inc. v. Levinson*. The court noted that issues of materiality are generally issues of fact, and thus normally reserved for trial. The Ninth Circuit then engaged in its own fact-specific inquiry and concluded that these allegations were sufficient to "'nudge[] [Appellants'] claims across the line from conceivable to plausible,'" as required to survive a motion to dismiss under the PSLRA.

The Ninth Circuit also found that the plaintiffs adequately pled scienter, even though their complaint failed to include any motive allegations. Viewed holistically — in light of Matrixx's alleged awareness of the potential link between Zicam and anosmia and its several statements in press releases, conference calls and SEC filings relating to Zicam — the Ninth Circuit concluded that the inference of scienter was "'cogent and at least as compelling' as any 'plausible non-culpable explanation'" that Matrixx "withheld the information intentionally or with 'deliberate recklessness.'" Accordingly, the Ninth Circuit concluded, under *Tellabs v. Makor Issues & Rights, Ltd.*, that plaintiffs satisfactorily pled scienter.

PSLRA SANCTIONS

ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., No. 08-1815-cv (2d Cir. Sept. 2, 2009)

Click here to view the opinion.

Second Circuit Affirms Sanctions Award Against Frivolous Claims

The U.S. Court of Appeals for the Second Circuit (with Judge Dennis Jacobs writing for the panel) affirmed the district court's award of sanctions under Rule 11 and the PSLRA's mandatory sanctions provision against the lawyers who had filed frivolous claims against Knight Capital Markets, LLC. Even though the Second Circuit's decision in *In re Pennie & Edmonds LLP*, required the district court to find subjective bad faith before it could impose sanctions *sua sponte* at the close of litigation, the panel explained that no finding of subjective bad faith was required when proceeding under the PSLRA's provision. First, the PSLRA states that it did not alter the existing standards for assessing sanctions, which in 1998 — predating *Pennie* — were always assessed under the "objectively reasonable" standards. Second, unlike the situation in *Pennie*, where the district court assessed sanctions *sua sponte* and therefore deprived counsel of the opportunity to withdraw or amend, the PSLRA's provision puts litigants and counsel on notice that the district court must make Rule 11 findings at the close of the case, and therefore sanctions findings under the PSLRA's mandatory sanctions provision are never truly *sua sponte*. The panel, however, remanded the case to the district court to assess the proper amount of sanctions. Even though the presumption under the PSLRA's mandatory sanctions provision is the opposing party's reasonable attorneys' fees and expenses incurred in the action, the panel noted that the PSLRA's mandatory sanctions provision may incentivize a party to wait until the close of securities litigation to increase costs that can be shifted onto opposing counsel. Consequently, the panel instructed the district court to consider whether awarding Knight Capital Markets the full amount of request fees was reasonable in light of its failure to move for Rule 11 sanctions before the suit was dismissed and the district court invited briefing on sanctions under the PSLRA.

SCIENTER

In re iMergent Sec. Litig., No. 2:05-CV-204 (D. Utah Oct. 30, 2009)

Click here to view the opinion.

Utah Federal Court Dismisses Securities Fraud Claim Against Auditor Grant Thorton for Lack of Scienter

Judge Dee Vance Benson of the U.S. District Court for the District of Utah dismissed for failure to sufficiently plead scienter a putative class action suit alleging violations of Section 10(b) (and Rule 10b-5 promulgated thereunder) of the Securities Exchange Act by iMergent's outside auditor Grant Thornton LLP, following the settlement of similar claims against iMergent itself and some of its executives. According to the complaint, Grant Thornton recklessly misapplied SOP 97-2, a GAAP provision that allows a company to recognize revenue from the sale of software only when, among other things, the "collectibility [of the revenue] is probable." According to the complaint, Grant Thornton accepted an erroneous interpretation of the "collectibility is probable" requirement of SOP 97-2 by finding that collectibility is probable when it is "more likely than not." After the financial statements were issued, the SEC explained that the phrase "collectibility is probable" means "the likelihood of collection [is] *substantially* higher than 50%" — *not* as Grant Thornton understood. Shortly after receiving the SEC's explanation, iMergent restated its financial statements to account for the fact that revenue and income had been improperly reported by more than $100 million during the class period. Upon the announcement of the restatement, iMergent's stock price dropped significantly. Plaintiffs alleged that Grant Thornton was reckless in applying a "more likely than not" standard because the relevant literature makes clear that "probable" requires a collection rate that is significantly higher than "more likely than not." Grant Thornton contended that a difference of opinion about the definition of "collectibility is probable" is insufficient to infer scienter under the federal securities laws. The district court agreed with Grant Thornton and dismissed the action.

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The district court explained, consistent with other courts, that when securities fraud claims are brought against an outside auditor, "the meaning of reckless is 'especially stringent,' ... 'approximat[ing] an actual intent to aid in the fraud being perpetrated by the audited company.'" Under this analysis, "GAAP violations, *without more*, fail to raise an inference of scienter." In the case at bar, the court found that "there is nothing to indicate that Grant Thornton was aware of, but turned a blind eye" to the "relevant literature." While noting that an auditor's access to the company records and information may, in some cases, support an inference of scienter, the court found that "this is not such a case." Nor did the magnitude of the restatement — a factor often relevant to an inference of scienter — apply in this case because plaintiffs "provide[d] no factual support or explanation as to how the magnitude of the restatement provides or enhances any inference that Grant Thornton acted with scienter." Finally, plaintiffs' attempt to support an inference of scienter by pointing to alleged auditor "red flags" was unavailing. Specifically, plaintiffs failed to allege that iMergent's correspondence with the SEC — which plaintiffs contended contained "red flags" — "would have alerted Grant Thornton to the fact that it was using an incorrect standard." In sum, the court found that plaintiffs' allegations, while they may "suggest negligence, ... fail[ed] to rise to the level necessary to support a claim under Section 10(b) and Rule 10b-5," especially in light of the court's findings both that Grant Thornton "did not appear to be attempting to conceal or hide [its] approach" and did not appear to have a motive to engage in fraud. Accordingly, the court dismissed the action with prejudice.

Horizon Asset Mgmt. Inc. v. H&R Block, Inc., No. 08-1593 (8th Cir. Sept. 9, 2009)

Click here to view the opinion.

Eighth Circuit Affirms Dismissal Based on Lack of Scienter, But Requires Court to Consider Nonlead Plaintiffs' Unasserted Claims

The Eighth Circuit, in an opinion authored by Judge Steven M. Colloton, affirmed the dismissal of a putative consolidated class action against H&R Block, Inc. and a number of its directors and officers (collectively, Block) involving claims under Section 10(b), Rule 10b-5 promulgated thereunder and Section 20(a) of the Securities Exchange Act but reversed and remanded the case regarding the district court's appointment of lead plaintiff. Between June 2005 and February 2006, Block twice announced that it would restate its financial results. Additionally, in 2006, the attorneys general of California and New York filed suit against Block for different products it offered. These events led to nine separate actions in state and federal courts, which were eventually consolidated. The district court appointed Horizon Asset Management Inc. (Horizon) as the sole lead plaintiff. Against the expressed desire of the other plaintiffs, Horizon only pursued claims under federal securities laws and did not bring derivative claims. The district court granted Block's motion to dismiss the claims brought by Horizon for failure to adequately plead scienter. Horizon appealed the dismissal, and the nonlead plaintiffs appealed Horizon's appointment as sole lead plaintiff.

As to Horizon's appeal of the dismissal of the federal securities claims, the Eighth Circuit affirmed that plaintiffs failed to adequately plead scienter. Critical to its finding, the court noted that "as soon as the accounting errors were discovered," Block acted promptly to investigate them, "a prudent course of action that weakens rather than strengthens an inference of scienter," and promptly disclosed the control weaknesses. The complaint's inclusion of purported statements by a confidential witness did not alter the result, as the allegation did not "provide the sources' basis of knowledge." Nor could plaintiffs' allege scienter by pointing to analyst reports that purportedly misinterpreted Block's disclosures because "[s]tatements made by third-party securities analysts … are insufficient to raise a strong inference of scienter where, as here, there are no allegations that the defendants adopted the statements, represented that they were true, used the analysts as conduits by providing them false information, or otherwise became 'entangled' with the analysts." Equally unavailing were plaintiffs' allegations that the individual defendants signed SOX certifications, received bonuses based on corporate performance and wanted to ensure the company's success — these facts, without more, could not support the necessary strong inference of scienter. Finally, plaintiffs could not prove scienter by showing

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"severe recklessness," as none of the allegations against the individual defendants amounted to "highly unreasonable conduct or an extreme departure from standards of ordinary care."

In regards to Block's liability as a corporation, the Eighth Circuit noted that the appropriate standard for considering corporate scienter was an open question in the Eighth Circuit. The plaintiffs argued that the alleged scienter of Block's vice president for Corporate Tax, even though not a named defendant, could be imputed to the company. Without resolving the issue, the court found that, even if the vice president's intent could be imputed to Block, plaintiffs failed to adequately plead scienter. Accordingly, the Eighth Circuit affirmed the dismissal of the federal securities claims against both the individuals and Block.

The Eighth Circuit did, however, reverse the district court's appointment of Horizon as the sole lead plaintiff. Specifically, the district court erred in selecting a lead plaintiff that was unwilling to bring the derivative claims asserted by the nonlead plaintiffs. Because a consolidated case "'retain[s] its independent status' and plaintiffs in a consolidated action … are still 'entitled to a decision on the merits of their claims,'" it was error for the court not to allow the nonlead plaintiffs to bring a separate complaint asserting derivative claims.

SECURITIES ACT

Ark. Pub. Employee Ret. Sys. v. GT Solar Int'l, Inc., No. 08-cv-312-JL (D.N.H. Oct. 7, 2009)

Click here to view the opinion.

New Hampshire Federal Court Upholds Claims Against GT Solar and Executives in IPO Document Disclosure Dispute

Judge Joseph N. Laplante of the U.S. District Court for the District of New Hampshire has upheld claims that GT Solar, four officers (the CEO, CFO, general counsel and the controller), five directors (including the nonexecutive chairman) and six underwriters violated Sections 11 and 12(a)(2) of the Securities Act by failing to disclose in GT Solar's IPO registration statement or prospectus the alleged "substantial likelihood" that its biggest customer would stop buying its products. The morning after its IPO, GT Solar's biggest customer (LDK Solar Co., Ltd.) issued a press release stating that it had entered into a contract to buy from one of GT Solar's competitors. The complaint pointed to statements in the IPO registration statement and prospectus about how GT Solar's product was "market leading"; promoted recurring sales "because of the high cost associated with changing equipment suppliers"; and that LDK "accounted for 62 percent" of GT Solar's revenue as purportedly misleading. Insofar as the Section 11 and 12(a)(2) claims were premised on nondisclosure, Rule 9(b) does not apply because fraud is not an element of those claims under First Circuit precedent.

Judge Laplante explained that the defendants' knowledge of the challenged statements was not an element of the claims. Additionally, the court rejected the defendants' attempt to assert the statutory defense of reasonable investigation, because the timing of LDK's press release created an inference that the defendants knew there was a substantial likelihood that LDK would purchase products from a GT Solar competitor. Second, the challenged statements were statements of present fact and therefore not mere puffery. Consequently, those statements could be considered misleading under Sections 11 and 12(a)(2) because the defendants did not disclose that the products might not remain market-leading. Because the prospectus's cautionary statements did not clearly disclaim or discount the inference that GT Solar's market-leading position would continue, the bespeaks caution doctrine did not apply; further, the PSLRA's safe harbor provision does not apply to "statements made in connection with an initial public offering." Third, loss causation was sufficiently pled because the price of GT Solar's stock dropped "in trading 15 times the average volume" after LDK issued its press release. Finally, the complaint adequately pled controlling person liability against the venture capital funds that own a controlling interest in GT Solar, as they controlled their employees who were directors who signed the allegedly misleading prospectus.

Landmen Partners Inc. v. Blackstone Group, L.P., No. 08-CV-3601 (HB) (S.D.N.Y. Sept. 22, 2009)

Click here to view the opinion.

S.D.N.Y. Dismisses Material Misstatements and Omissions Claims Related to Blackstone Group IPO

Judge Harold Baer, Jr. of the U.S. District Court for the Southern District of New York dismissed claims that Blackstone Group, L.P. and four of its executives violated Sections 11 and 12(a) of the Securities Act by making material misstatements and omissions in Blackstone's Registration Statement and Prospectus filed in connection with its IPO. To plead Section 11 and 12(a) claims, the complaint must allege only that the offering document contained a material misrepresentation or omission as of its effective date. A fact is material if there is "'a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" Further, Section 11 and 12(a) claims will be subject to Rule 9(b)'s heightened pleading standard only if they sound in fraud; the complaint, however, sounded only in negligence.

Judge Baer determined that two of the alleged omissions — Blackstone's failure to disclose that it had invested in FGIC (a monoline financial guarantor), which it subsequently wrote down, and that one of its other investments, Freescale, had lost its exclusivity agreement with its biggest client shortly before Blackstone's IPO — were not material because neither omission exceeded the quantitative or qualitative threshold to be considered material. In *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, the Second Circuit endorsed a five percent quantitative threshold for determining materiality in this securities laws context. Blackstone's investments in FGIC and Freescale were 0.4 percent and 3.6 percent, respectively, of its assets under management, and its subsequent write-down of its FGIC investment was 0.4 percent of Blackstone's annual revenue. Further, the omissions were not qualitatively material because they did not conceal unlawful transactions or conduct, they "did not relate to a 'significant aspect of [Blackstone's] operations' as a whole," and the markets did not act negatively to their public disclosure.

The judge also determined that "Blackstone's failure to specifically address the deteriorating real estate market" was not a material omission, nor was its representation that real estate was "'experiencing historically high levels of growth and liquidity'" a material misstatement, because the complaint did not connect the problems in the subprime residential mortgage segment to Blackstone's real estate investments. Under *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*, without "'factual enhancement' as to *how*" the deteriorating market would materially impact Blackstone's investments, allegations that Blackstone invested in real estate and that the real estate market was starting to deteriorate were insufficient to plead a plausible claim. Further, Sections 11 and 12(a) did not require Blackstone to disclose general market conditions (such as the general decline in the real estate market). Although Item 303 requires companies to disclose known trends, the complaint did not plead that Blackstone knew of trends that "were reasonably likely to have a material effect on *its* portfolio of real estate investments"; the complaint's generalized allegations about how problems in the market could have "made it 'foreseeable' that a particular set of unidentified investments would sour" did not give rise to a plausible claim under *Twombly*.

SEC ENFORCEMENT ACTIONS

Sec. & Exch. Comm'n v. Kelly, No. 08 Civ. 4612 (CM) (S.D.N.Y. Sept. 30, 2009)

Click here to view the opinion.

S.D.N.Y. Denies Motions to Dismiss SEC Claims Against AOL Executives

Judge Colleen McMahon of the U.S. District Court for the Southern District of New York denied motions to dismiss the SEC's claims that four senior managers at America Online, Inc. (which became AOL Time Warner, Inc.) violated — or aided-and-abetted violations of — Section 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(5) of the Securities Exchange Act (as well as seven rules promulgated thereunder). The SEC claimed that the four senior managers caused AOL to engage in gross-ups of counterparty transac-

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tions ultimately "allowing AOL to fraudulently recognize its own money as revenue." (For example, in one of these transactions, Sun "would agree to 'buy' $37.5 million of advertising from AOL in exchange for AOL's commitment to purchase $250 million in equipment.") Judge McMahon determined that the misrepresentations about AOL's advertising revenue caused by the defendants were material because AOL had to restate its revenues to correct the improper recognition of advertising revenue, which was only required under GAAP if the error was material. Further, the SEC's claims were adequately pled with the particularity required by Rule 9(b) to put the defendants on fair notice of the SEC's claims, because the complaint identified the defendants, the specific fraudulent acts and statements they made, when they made them, that they did so to profit by selling their stock at inflated prices and that they misled AOL's auditors.

Similarly, relying on *Ashcroft v. Iqbal*, the court determined that the complaint established a strong inference of scienter, because it alleged that the defendants "intentionally" violated the securities laws knowing AOL's public statements about its advertising revenue were incorrect, and benefited by selling their stock at artificially inflated prices. Finally, Judge McMahon concluded that the SEC's claims were not barred by the statute of limitations. Based on "the great weight of the case law," its equitable claims were not subject to any limitations period — only its request for civil penalties. Although the request for civil penalties was subject to the five-year catch-all limitations period in 28 U.S.C. § 2462 and the complaint was not filed until May 2008, the SEC's claims for civil penalties were not time-barred. The limitations period for each defendant had (due to agreements with the SEC) been tolled for at least one year, and the continuing violation doctrine (*i.e.*, the limitations period on fraud does not run until the last step is completed) applied because the SEC alleged "a continuous, integrated scheme" lasting until January 2003.

Sec. & Exch. Comm'n v. Patel,
No. 07-cv-39-SM
(D.N.H. Sept. 30, 2009)

Click here to view the opinion.

New Hampshire Federal Court Dismisses SEC Claims Due to Unacceptable Supplemental Filings

In a case characterized as involving the SEC's "laboring mightily to pound a number of square pegs into round holes of individual liability," Chief Judge Steven J. McAuliffe of the U.S. District Court for the District of New Hampshire dismissed the majority of the SEC's claims against six officers at Cabletron, Aprisma and Enterasys (Cabletron's CEO; Cabletron's CFO and COO and Aprisma's COO; Cabletron's Vice President of Corporate Affairs; Enterasys's Controller; Aprisma's CEO; and an executive vice president at Cabletron and Enterasys's COO). The SEC alleged those individuals collectively violated Sections 17(a)(1)-(3) of the Securities Act; Sections 10(b), 13(a), 13(b)(2)(A)-(B) and 13(b)(5) of the Securities Exchange Actl; and the rules promulgated under those acts, to artificially inflate the financial condition of Cabletron, Enterasys and Aprisma to make it appear as if they were all viable stand-alone companies. Because the SEC had filed a prolix complaint full of what the court characterized as "shotgun" and "puzzle" pleading, the SEC had been ordered to file a supplemental filing identifying specific allegations relating to each claim against each defendant.

The court determined that the SEC's supplemental filing was unhelpful and did not necessarily identify the correct allegations in support of a given claim against a given individual, "which is, at best, unacceptable inattentiveness or, at worst, deliberate obfuscation." After reviewing the filing, carefully examining the complaint and applying Rule 9(b)'s heightened pleading requirements, Judge McAuliffe determined that the SEC had properly stated a Section 17(a)(1) claim against four defendants, limited Section 17(a)(2) and (3) claims against five defendants, a Section 10(b) claim against all defendants, a Section 13(b)(5) claim against five defendants, and a Rule 13b-2 claim against three defendants. Further, those claims were limited based on the court's review of the relevant allegations of the complaint (whether or not those allegations were identified by the SEC in its supplemental filing). The other claims were dismissed; when dismissing the Section 13(b)(2)(A) claim against Cabletron's CFO and COO, Judge McAuliffe noted that, "ironically," the SEC's original complaint stated that claim, but "because the SEC has not bothered to point" out the allegations in its amended complaint supporting the claim, "even though directly asked to do so," the claim should be dismissed.

SECURITIES FRAUD PLEADING STANDARDS

Ind. State Dist. Council of Laborers v. Omnicare, Inc., No. 07-6379 (6th Cir. Oct. 21, 2009)

Click here to view the opinion.

Sixth Circuit Affirms Dismissal of Complaint That Tries 'to Turn Bad Corporate News Into a Securities Class Action'

The U.S. Court of Appeals for the Sixth Circuit, in an opinion authored by Judge Richard Mills (of the Central District of Illinois, sitting by designation), affirmed, in large measure, the dismissal of a putative securities class action relating to a variety of alleged misstatements made by pharmaceutical care provider Omnicare, Inc. and certain officers and directors (collectively, Omnicare). The complaint alleged that Omnicare made misleading statements or failed to disclose (1) the company's lack of readiness to adapt to a new governmental voluntary prescription program, Medicare Part D; (2) the company's contract dispute with a major prescription drug plan (PDP) sponsor, UnitedHealth Group ("UHG"); (3) the company's alleged violations of GAAP; and (4) the company's purported illegal drug recycling and drug substitution program. Plaintiffs brought claims for violations of Section 10(b), Rule 10b-5 promulgated thereunder and Section 20(a) of the Securities Exchange Act, as well as Section 11 of the Securities Act.

In the opening line of its order, the Sixth Circuit characterized the complaint as follows: "Seizing on a few vague statements from management, the plaintiffs try to turn bad corporate news into a securities class action." But, the PSLRA, the court explained, "forbids such alchemy." As to Omnicare's alleged misstatements relating to its preparation to transition to Medicare Part D, the Sixth Circuit found that plaintiffs failed to adequately plead loss causation, as the allegations neither identified how the purported falsity of Omnicare's misstatements became public nor how Omnicare's alleged misstatements about Medicare Part D (and not other news) caused the ensuing decline in Omnicare's stock price. Likewise Plaintiffs' claim based on Omnicare's alleged GAAP violations also failed to adequately plead loss causation, since the complaint did not disclose how and when, if ever, the purported GAAP violations were revealed to the market. As to Omnicare's alleged failure to disclose its contractual dispute with UHG, the Sixth Circuit found that Omnicare was under no duty to disclose such information any earlier than it did, and that nothing that it said to the public triggered such a duty to disclose. Finally, the court held that Omnicare's alleged misstatements that it was acting in compliance with the law were not sufficiently specific to support a Section 10(b) claim. Although the complaint was supported by the account of a confidential witness who purportedly affirmed that Omnicare knew that the company was engaged in certain illegal practices, the court "steeply discounted" the confidential witness' account because the complaint provided no information about him other than his job title. The court further discounted the significance of the confidential witness' account because the allegations of illegality raised by the confidential witness were different than those allegedly revealed to the market. Moreover, Omnicare's general statements about legal compliance were "soft" information that did not trigger any requirements of further disclosure. Accordingly, the Sixth Circuit affirmed the district court's dismissal of plaintiff's Section 10(b) claim and also affirmed dismissal of the Section 20(a) "controlling persons" claim against Omnicare's officers because no primary securities-law violation had been found.

The Sixth Circuit did, however, reverse the district court's dismissal of plaintiffs' Section 11 claim, which the district court also dismissed based on plaintiffs' failure to adequately plead loss causation. The Sixth Circuit held that, unlike a 10(b) claim, loss causation is an affirmative defense to a Section 11 claim, not an element of the claim that must be alleged by plaintiff. Accordingly, the Sixth Circuit concluded that the district court erred in dismissing the Section 11 claim for failure to adequately plead loss causation and remanded the case to the district court for further proceedings.

In re 2007 Novastar Fin. Inc., Sec. Litig., No. 08-2452 (8th Cir. Sept. 1, 2009)

Click here to view the opinion.

Eighth Circuit Affirms Dismissal With Prejudice for Failure to Satisfy PSLRA'S Pleading Requirements in Mortgaged-Backed Securities Action

The U.S. Court of Appeals for the Eighth Circuit, in an opinion authored by Judge Raymond Gruender, affirmed the dismissal with prejudice of a putative securities class action based on plaintiffs' failure to satisfy the heightened pleading requirements of the PSLRA. Plaintiffs' consolidated class action complaint alleged that Novastar Financial, Inc. and certain executives (collectively, Novastar) violated Section 10(b), Rule 10b-5 promulgated thereunder, and Section 20 of the Securities Exchange Act by making false and misleading statements about the operations and financial health of Novastar, a publicly traded company that, among other things, bundles groups of loans into mortgage-backed securities and sells the rights to the income generated by the securities. Novastar allegedly announced financial results and a financial outlook that were below expectations, resulting in its stock price dropping by 40 percent in a single day.

Reviewing the dismissal *de novo*, the Eighth Circuit held that the complaint failed to satisfy PSLRA's pleading requirements. Most critically, although the complaint contained a 36-page section titled "Defendants' False and Misleading Statements Issued During The Class Period" — which reproduced lengthy excerpts from press releases, SEC filings and transcripts of conference calls attributed to Novastar — there was no "indication as to what specific statements within these communications are alleged to be false or misleading." Nor did plaintiffs, by highlighting and italicizing certain language in the materials, fulfill their burden to identify the false and misleading statements within these lengthy excerpts. Further supporting dismissal was the complaint's failure to state with adequate specificity why any of the statements at issue were false or misleading. Finding that plaintiffs failed to adequately plead these basic facts, the court affirmed dismissal of the complaint.

The Eighth Circuit also affirmed the dismissal with prejudice as not an abuse of discretion. Dismissal with prejudice was appropriate in light of plaintiffs' failure to proffer, in seeking leave to amend, a proposed amended complaint. Plaintiffs were unable to overcome this failure by pointing to a footnote, in their opposition to Novastar's motion to dismiss, that requested an opportunity to amend if the court were to grant the motion to dismiss. This footnote did not excuse their failure to timely and properly seek leave to amend or reconsideration.

City of Roseville Employees' Ret. Sys. v. Horizon Lines, Inc., No. 08-969 (D. Del. Nov. 13, 2009)

Click here to view the opinion.

Delaware Federal Court Dismisses 10(b) Claims in Alleged Rate-Fixing Scheme

In a putative class action, Chief Judge Harvey Bartle III of the U.S. District Court for the District of Delaware dismissed claims that Horizon Lines, Inc., two of its subsidiaries and six current or former executives violated Section 10(b) of the Securities Exchange Act. Horizon Lines, Inc.'s General Manager, its vice president for marketing and its marketing and pricing director for Horizon's Puerto Rico operations were indicted and pled guilty to engaging in an illegal rate-fixing scheme within Horizon's Puerto Rico market. The complaint alleged that the defendants' failure to disclose that scheme while attributing Horizon's increase in revenue to legitimate business practices constituted a material misrepresentation or omission. In particular, the complaint pointed to Horizon's code of ethics (which stated that Horizon's policy was to comply with American antitrust laws), Horizon's SEC filings, press releases and earnings calls with the CEO, the president and the CFO, who said that Horizon's results were based on strong business practices and increased margins (*e.g.*, stringent cost controls, rate increases, market discipline).

Judge Bartle determined that Horizon's act of publishing its code of ethics was not a material misrepresentation under the PSLRA, because the SEC mandated Horizon publish that code of ethics, and its adoption did not amount to a representation that all of Horizon's executives were abiding by it. Similarly, the CEO's and CFO's Sarbanes-Oxley certifications -that, to their knowledge, Horizon's financial results were accurate and internal controls were effective - were not material misrepresentations, nor was there a private right of action in connection with those certifications. Further, although the complaint adequately pled material misrep-

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resentations (because attributing Horizon's success to only lawful conduct "falls below the level of honesty required" and investors would consider the illegal rate-fixing scheme material), scienter was not adequately pled. The court explained that the complaint did not tie any individual with knowledge of the scheme (*e.g.*, the three indicted former executives) to any individual or entity who made an allegedly false public statement (e.g., the CEO, the CFO, the president and Horizon Lines, Inc.). There was no inference that the CEO, the CFO or the president knew of the rate-fixing conduct, even though the complaint relied upon a confidential witness who claimed that the CEO authorized all rates, because the complaint did not plead with particularity that the CEO, CFO and President were aware of the price-fixing conduct or had access to information allowing them to discover that conduct, or that the rates charged by Horizon's Puerto Rico operations were "so suspicious" that they should have been concerned. With regard to the allegations against Horizon Lines, Inc., the court held that it was not enough to establish fraud on the part of a corporation that one corporate officer makes a false statement that another officer knows to be false. To plead scienter, Judge Bartle wrote, a plaintiff must identify facts raising a strong inference that false or misleading statements were made or otherwise promoted by an individual acting on behalf of the company who knew or was reckless in not knowing that the statements were false or misleading. Finally, the court held that Horizon Lines, LLC and Horizon Lines of Puerto Rico, Inc. had not violated Section 10(b) because the complaint did not allege that either entity made any misrepresentations or had misrepresentations made on their behalf.

Healthcare Fin. Group, Inc. v. Bank Leumi USA, No. 08 Civ. 11260 (VM) (S.D.N.Y. Oct. 23, 2009)

Click here to view the opinion.

S.D.N.Y. Dismisses 10(b) Claims Against Bank Leumi USA

Judge Victor Marrero of the U.S. District Court for the Southern District of New York dismissed claims that Bank Leumi USA violated Section 10(b) of the Securities Exchange Act by recommending that the plaintiff invest in a specific auction rate security. The court also declined to exercise supplemental jurisdiction over the fraud and negligent misrepresentation claims, dismissing them as well. After the auctions began to fail for that security and the issuer defaulted, the plaintiff claimed that Bank Leumi misrepresented the stability and liquidity of auction rate securities and did not provide it with prospectuses or basic information about how auction rate securities functioned, including the role underwriters played through the use of last-minute bids to prevent auction failures.

Judge Marrero determined that the Section 10(b) claim failed because the plaintiff did not allege loss causation. Although the plaintiff alleged "transaction causation" (because it would not have purchased the auction rate securities but for the purported misrepresentations), the purported misrepresentations and omissions were not alleged to have caused the auction failures, making the plaintiff's investment illiquid. Moreover, the collapse of the market for the plaintiff's auction rate securities was not alleged to have been caused by a corrective disclosure of the purported misrepresentations and omissions. In addition, the plaintiff was denied leave to amend, because the complaint had already been amended once and, to remedy its failure to allege loss causation, the plaintiff would need to plead "a completely different set of misrepresentations and omissions," which would effectively constitute filing a new action.

In re Dynex Capital, Inc. Sec. Litig., No. 05 Civ. 1897 (HB) (S.D.N.Y. Oct. 19, 2009)

Click here to view the opinion.

S.D.N.Y. Denies Motion to Dismiss Claims Against Mobile Home Lender for Its Underwriting Guidelines

Applying Rule 9(b) and the PSLRA's heightened pleadings requirements, Judge Harold Baer, Jr. of the U.S. District Court for the Southern District of New York denied a motion to dismiss claims that Dynex Capital, Inc. and two of its senior executives violated Section 10(b) of the Securities Exchange Act. The complaint alleged that the defendants, who originated and securitized loans for mobile homes, violated Section 10(b) by making material misstatements about their compliance with their own underwriting standards and by misrepresenting the reasons that those loans were failing. The complaint pled that defendants materially misrepre-

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sented that they had general "underwriting guidelines" because the defendants systematically disregarded those guidelines when determining whether to issue a loan. Further, defendants' attempt to blame loan losses on market conditions was a misrepresentation because — although some loan losses were based on market conditions (*e.g.*, the difference between the loan values and the amounts recovered at foreclosure sale) — the defendants failed to disclose, as they were obligated to, that their origination practices resulted in loans with inherent defects which could not be foreclosed upon (*e.g.*, the loan was a "buy for" loan and defendants were unable to contact the owner of the collateral — as opposed to the debtor — to foreclose). Similarly, the defendants' statements about their loss reserves were misleading in light of the number of loans with origination defects. The court further determined that the complaint adequately pled scienter, because management's directive to promote loan volumes resulted in a large number of facial defective (and uncollectible) loans. This conduct was deemed "reckless" because it was "an extreme departure from the standards of ordinary care," and the defendants should have been aware of it. Similarly, the officer defendants had knowledge of those defects by reviewing audit reports on the quality of Dynex's loans, because those audit reports contradicted their public statements or the officer defendants' statements reflected an egregious refusal to see the problems with the quality of their loans as shown by those reports. The complaint, however, did not plead that the defendants acted with motive and opportunity, because a generalized motive to halt a drop in stock price or to preserve incentive compensation was insufficient. Moreover, when viewed "holistically," the inference of scienter was at least as compelling as alternative inferences, as the defendants' public statements in light of their knowledge made it at least as compelling as the possibility of mistake. The complaint pled loss causation by tying the decline in price of the securitized loans to ratings agency actions taken as a consequence of the defendants' restatement of losses. Finally, the complaint was not time-barred, because the limitations period only began to run when the last of the fraudulent statements were made, which was within five years of the complaints' filing.

Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., No. 08 Civ. 7508 (SAS) (S.D.N.Y. Oct. 15, 2009)

Click here or here to view the opinions.

S.D.N.Y. Provides Mixed Ruling on Insolvent Structured Investment Vehicle's Ratings

Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York upheld claims under Rule 9(b)'s heightened pleading standards that Morgan Stanley & Co., Moody's Investors Service and Standard & Poor's Rating Services had committed common-law fraud in connection with the structure and pricing of notes issued by an insolvent structured investment vehicle (SIV), but dismissed all other claims against Morgan Stanley, the ratings agencies and Bank of New York Mellon. The case involved claims that Morgan Stanley worked with the rating agencies to structure and monitor the SIV so that its notes would have high ratings from those rating agencies; those ratings then determined how much the ratings agencies were paid. Judge Scheindlin explained that the complaint adequately alleged that the ratings agencies made actionable misstatements by issuing the high, but false and misleading, ratings for the SIV, which were then disseminated with those rating agencies' consent to potential investors. Although the ratings agencies claimed the First Amendment protected them from liability for their ratings, the court explained that the First Amendment defense was unavailable because the complaint "plainly alleged" that, instead of being widely disseminated, the ratings for the SIV's notes were provided only to a select group of investors. Similarly, even though the ratings were opinions, the court determined that they were actionable because the complaint sufficiently pled that the ratings agencies did not genuinely or reasonably believe in their ratings. In addition, the complaint adequately alleged actionable misrepresentations by Morgan Stanley, because it designed, structured, marketed and maintained the SIV with the ratings agencies and then transmitted their ratings of the SIV's notes to potential investors.

Judge Scheindlin further held that the complaint "plausibly" pled that Morgan Stanley and the ratings agencies knew the ratings were false (because they knew how risky the SIV's investments were and the ratings agencies could not be objective due to their contingent and ongoing compensation) and acted with scienter (the ratings agencies wanted continued business from

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Morgan Stanley and the high fees associated with sales of the SIV's notes, and Morgan Stanley wanted to earn fees from the SIV and distributed sales documents that included the high, but false, ratings). Finally, the court determined that the complaint sufficiently pled reasonable reliance, because sophisticated investors reasonably can rely upon rating agencies' ratings, especially as they had access to nonpublic information and the investors did not. However, Judge Scheindlin dismissed the claims for negligence, negligent misrepresentation, breach of fiduciary duty and unjust enrichment — but not the claim for tortious inference with contract — as those claims involved conduct in New York and were therefore preempted by New York's Martin Act, N.Y. Gen. Bus. Law § 352-c (tortious inference claims are not preempted by the Martin Act). The court also dismissed claims for breach of contract, including third-party beneficiary claims, because the complaint did not plead that contracts enforceable by the plaintiffs existed or that the plaintiffs were intended third-party beneficiaries of any contracts that the complaint did plead existed. Judge Scheindlin later dismissed the breach-of-contract claims with prejudice (because the plaintiffs did not identify any contracts they were a party to despite limited discovery) and dismissed the aiding-and-abetting claim against the Bank of New York Mellon without prejudice (because additional discovery could possibly make that claim plausible).

In re Par Pharm. Sec. Litig.,
No. 06-cv-3226 (PGS)
(D.N.J. Sept. 30, 2009)

Click here to view the opinion.

New Jersey Federal Court Denies Motion to Dismiss (10)b Claims Relying on Confidential Informants

Judge Peter G. Sheridan of the U.S. District Court for the District of New Jersey denied a motion to dismiss purported class claims that Par Pharmaceuticals Companies, Inc., its CEO between 2003 and 2006 (Scott Tarriff), and its CFO until 2006 (Dennis O'Connor) violated Section 10(b) of the Securities Exchange Act by misstating Par's accounts receivable and inventory, and consequently misstating Par's financial results. The complaint relied upon six confidential informants to allege a strong inference of scienter by Par, Tarriff and O'Connor.

Applying *Institutional Investors Group v. Avaya, Inc.*, Judge Sheridan determined that the complaint provided sufficient details about the source of the confidential informants' allegations, because, among other things, it provided their job titles, years of employment and job responsibilities. Applying Rule 9(b)'s and the PSLRA's heightened pleading requirements, the court concluded that the complaint adequately pled scienter with respect to Par, Tarriff and O'Connor over both the accounts receivable and the inventory misstatements. One of the confidential informants alleged that he was building an automated accounting method to replace Par's existing Excel spreadsheet-based accounts receivable system, that the Excel spreadsheet was "consistently five to 10 percent higher," and that he provided daily reports about that difference to Tarriff and O'Connor. Because they "continued" with the "more profitable, outdated Excel spreadsheet methodology" and did not investigate whether to increase Par's accounts receivable reserves as a result of those reports, the complaint adequately alleged, at least circumstantially, that Tarriff and O'Connor acted with scienter. Further, that confidential informant was in sufficient proximity to them — he reported to another confidential informant who "regularly" attended senior management meetings.

Similarly, another confidential informant would prepare monthly inventory reports distributed to Par's senior management, including Tarriff and O'Connor. Those reports — and other regular reports senior management received — informed them of Par's inventory issues, and demonstrates that Tarriff's and O'Connor's failure to address that inventory problem constituted "either knowledge of the fraud or strong circumstantial evidence of conscious misbehavior or recklessness." Further, Judge Sheridan determined that the complaint adequately pled loss causation, because Par's stock price dropped the day after Par announced the accounting problems caused by the fraud, even though Par's stock price eventually recovered. That drop in price also demonstrated that the misstatements were material, because they "'significantly altered the "total mix" of information' available." Finally, the misstatements were not forward-looking — and thus not subject to the PSLRA's safe harbor provision — or mere puffery because they misrepresented "historical facts." However, Judge Sheridan dismissed the

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purported class' claims against Par's CEO who preceded Tarriff because the complaint did not sufficiently allege scienter on his part. He had resigned from Par before the daily reports regarding the accounts receivable discrepancy began, and there were not particular allegations about him with respect to the inventory problems.

Johnson v. Pozen Inc., No. 1:07CV599 (M.D.N.C. Sept. 29, 2009)

Click here or here to view the opinions.

North Carolina Federal Court Dismisses Claims Over Timing of FDA Drug Approval

Senior Judge N. Carlton Tilley, Jr. of the U.S. District Court for the Middle District of North Carolina adopted Magistrate Judge Wallace W. Dixon's February 19, 2009, recommendation to dismiss purported class claims that Pozen Inc., its CEO, its CFO and its executive vice president of product development violated Section 10(b) of the Securities Exchange Act by misrepresenting when the FDA was going to approve its drug Trexima. The complaint charged that Pozen and its CEO represented that the FDA would approve the drug in August 2007 when they knew — and did not disclose — the FDA's concerns with genotoxicity data for Trexima (an attempt to measure its likelihood of causing cancer) based on a pair of positive FDA-requested studies. However, because Pozen disclosed that the FDA had safety concerns — as opposed to the more specific "'genotoxicity' concern" — and that preclinical testing had raised some safety concerns (as well as repeatedly cautioning that FDA approval of Trexima was not guaranteed), the court determined that Pozen did not fail to disclose the FDA's concerns or the approval process for Trexima. Moreover, the challenged statements were forward-looking statements protected by the PSLRA's safe harbor provision, because they were accompanied by meaningful, cautionary language (*e.g.*, "that preclinical data had raised genotoxicity concerns" and "could cause the FDA to deny or delay approval of Trexima"). Further, the court determined that scienter had not been pled; the "more compelling" inference based on the defendants' vague discussions of the genotoxicity test results in Pozen's press releases, conference calls and SEC filings is that the defendants considered the positive tests "minor" based on negative results in another, more reliable test. Finally, there was no evidence that the defendants doubted that Trexima would be approved by the FDA in August 2007 or knew that the FDA would require more information at that point.

In re Sanofi-Aventis Sec. Litig., Nos. 07-cv-10279 (GBD); 08-cv-00021 (GBD) (S.D.N.Y. Sept. 25, 2009)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims of 10(b) Violations Related to Alleged Omissions About Drug's Side Effects

Judge George B. Daniels of the U.S. District Court for the Southern District of New York dismissed purported class claims that Sanofi-Aventis and seven of its officers violated Section 10(b) of the Securities Exchange Act by making misrepresentations or omissions about side effects of a drug called "rimonabant," for which Sanofi-Aventis unsuccessfully sought to obtain FDA approval. Although Sanofi-Aventis had disclosed the results of four clinical trials "in numerous press releases, medical journals and during conference calls with market analysts," the complaint alleged that the defendants failed to disclose clinical data identifying an alleged connection between rimonabant and suicide. Applying Rule 9(b)'s and the PSLRA's heightened pleading requirements, Judge Daniels recognized that the complaint failed to plead facts showing that the defendants misstated the statistically observed frequency of rimonabant's side effects; thus, the defendants' characterization of the side effects was a nonactionable statement of opinion. Similarly, the complaint did not identify the information that defendants purportedly omitted. In addition, the court determined that the complaint did not adequately plead scienter because the sole allegation of motive — "to avoid increased scrutiny of outstanding drug applications" — was the type of generalized motive that is insufficient to establish scienter. Further, the complaint did not adequately plead scienter by showing the defendants acted recklessly, because the defendants "repeatedly disclosed" the side effects. Thus, their conclusion that those side effects were not statistically significant or sufficiently severe to preclude FDA approval of rimonabant was not reckless.

Hoffman v. AuthenTec, Inc., No. 6:08-cv-1741-Orl-28DAB (M.D. Fla. Sept. 24, 2009)

Click here to view the opinion.

Florida Federal Court Dismisses Claims, Citing Safe Harbor Provisions

Judge John Antoon II of the U.S. District Court for the Middle District of Florida dismissed claims that AuthenTec, its CEO and its CFO violated Section 10(b) of the Securities Exchange Act by making false and misleading statements in SEC filings, press releases and quarterly conference calls. The court dismissed the claims because all but one of the challenged statements were forward-looking statements protected by the PSLRA's safe harbor provision, and the complaint did not plead loss causation in connection with the sole remaining statement. The forward-looking statements all concerned future economic performance or AuthenTec's plans and objectives (*e.g.*, AuthenTec's February 2008 press release announcing its intent to begin shipping its product in the second half of 2008). Defendants were shielded from liability because the statements at issue were identified as forward-looking and made in the context of specific cautionary statements warning "'of risks of a significance similar to that actually realized.'" The statement by the CEO that AuthenTec's product had been adopted by three original equipment manufacturers was a misstatement due to the fact that it had only been adopted by two such manufacturers. However, Judge Antoon determined that the complaint did not adequately plead loss causation because the third original equipment manufacturer did adopt AuthenTec's product during the 10-month period before AuthenTec's stock experienced any price decline. Thus, even if the statement was arguably misleading when made, the subsequent adoption of the product cured any harm arguably caused by that statement.

Zisholtz v. SunTrust Banks, Inc., No. 1:08-CV-1287-TWT (N.D. Ga. Sept. 24, 2009)

Click here to view the opinion.

Georgia Federal Court Dismisses Claims in Auction Rate Securities Dispute

In a suit concerning auction rate securities, Judge Thomas W. Thrash, Jr. of the U.S. District Court for the Northern District of Georgia dismissed purported class claims that SunTrust Banks and one of its subsidiaries violated Rule 10b-5 because those claims were not adequately pled under Rule 9(b) or the PSLRA. As for the Rule 10b-5(b) claim, although the complaint alleged that "high level corporate officials" set out directives and uniform sales materials, which were allegedly misleading about the nature of auction rate securities (*e.g.*, their liquidity or how cash-like they were), the complaint did not identify *who* those specific officials were, *what* the directives and sales material contained, or *how* those directives and sales materials were distributed. In addition, none of the confidential witnesses in the complaint mentioned those directives or uniform sales materials. Consequently, Judge Thrash determined that a more plausible theory under *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* is that the senior officials at SunTrust acted negligently, and not intentionally — and consequently such conduct did not support a strong inference of scienter, as required for Rule 10b-5(b) claims.

As for the Rule 10b-5(a) and (c) claims, the court similarly concluded that the complaint did not specifically identify the manipulative auction practice that SunTrust allegedly committed. Instead, the complaint simply alleged that SunTrust "engaged in a wide range of deceptive and manipulative tactics." Further, the complaint did not allege how SunTrust engaged in the purported manipulations (*e.g.*, by stating which auction rate securities SunTrust purchased, and when, to manipulate the auctions). Finally, because the plaintiffs had already amended their complaint twice and did not explain what further amendments they would make in a third amended complaint, leave to amend was denied. In addition, Judge Trash denied the plaintiffs' request to lift the PSLRA discovery stay, because the plaintiffs did not meet their heavy burden to show undue prejudice or the likelihood that SunTrust would not preserve the relevant evidence.

Defer LP v. Raymond James Fin., Inc., No. 08 Civ. 3449 (LAK) (S.D.N.Y. Sept. 17, 2009)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Involving Auction Rate Securities and Broker-Dealers

Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York dismissed claims (with leave to amend) that Raymond James Financial (RJF), its broker-dealer subsidiary Raymond James & Associates, Inc. (RJA) and its brokerage subsidiary Raymond James Financial Services, Inc. (RJFS) violated Section 10(b) of the Securities Exchange Act by

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allegedly misrepresenting that auction rate securities (ARS) were equivalent to cash and how liquid ARS are, and that broker-dealers were intervening in ARS auctions and were artificially supporting the ARS market.

Applying Rule 9(b)'s and the PSLRA's heightened pleading requirements, the court determined that the complaint adequately pled that RJFS made misstatements and omissions to the plaintiff through her financial advisor (an RJFS employee), because the complaint identified the circumstances of those misstatements and omissions, what those statements were and why they were incorrect, and that RJFS purportedly directed its financial advisors to make similar representations. However, the complaint did not adequately allege that RJF or RJA made those misrepresentations, because the group-pleading doctrine does not apply to oral statements and because it was not alleged that either RJF or RJA were involved in RJFS's business. Similarly, it was not adequately pled that RJF or RJA made misrepresentations through RJFS's financial advisors as part of a larger scheme to sell ARS, because the circumstances of those misrepresentations were not sufficiently identified, nor did the complaint allege how RJF or RJA were responsible for those statements.

Judge Kaplan then concluded that it was inadequate, for pleading purposes, to demonstrate a strong inference of scienter by RJA and RJF by alleging they were interconnected with RJFS, which made the alleged misrepresentations. The complaint did not adequately allege that RJF, RJA and RJFS had the motive and opportunity to unload excess ARS, because it was not alleged that RJFS — as the marketing and sales entity — and RJA — as the underwriting entity — were aware of the other's conduct. Further, absent allegations concerning an agency relationship, what one subsidiary knew was required to be imputed to another simply because they shared a corporate parent. Similarly, the complaint did not adequately allege conscious misbehavior, because without allegations concerning its knowledge of RJA's conduct, RJFS could not be inferred to know it was fraudulently marketing ARS. The complaint could not simply assert a large fraud to show a conscious misbehavior or recklessness. In addition, Judge Kaplan rejected the plaintiff's argument that she was not required to plead scienter on an individualized basis due to the purported "'interconnectedness' of defendants' conduct," because — aside from RJFS's and RJA's relationship as RJF subsidiaries — there were no allegations "support[ing] a conclusion that RJF or RJA were aware of RJFS's alleged misstatements."

In re Citigroup Auction Rate Sec. Litig., Nos. 08 Civ. 3095 (LTS)(FM); 09md 2043 (LTS) (S.D.N.Y. Sept. 11, 2009)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Alleging Auction Rate Securities Manipulation

Judge Laura Taylor Swain of the U.S. District Court for the Southern District of New York dismissed purported class claims that Citigroup Inc., Citigroup Global Markets Inc. and Smith Barney violated Section 10(b) of the Securities Exchange Act and Sections 206 & 215 of the Investment Advisors Act by manipulating the auctions for auction rate securities (ARS) that they managed. The complaint alleged that the defendants had bid in those ARS auctions to prevent them from failing "to offset the negative impact of the subprime crisis," without informing the plaintiffs, and the plaintiffs had relied upon the integrity of the auctions in purchasing Citigroup ARS. Because the complaint alleged market manipulation, a lower level of specificity was required for the Section 10(b) claim under Rule 9(b)'s and the PSLRA's heightened pleading requirements than if the complaint alleged misrepresentations or omissions. However, Judge Swain determined that even under that lessened level of specificity the elements of the Section 10(b) claim had not been adequately pled, because the complaint did not adequately plead fraud, scienter, reliance or loss causation.

Fraud was insufficiently pled because the complaint did not include the required specific, particularized allegations of "which Defendants performed what manipulative acts at what times and with what effect." Similarly, the complaint did not plead a strong inference of scienter, because the complaint's conclusory basis — a desire to sell ARS to offset subprime market losses — was not equally compelling as the alternative inference that the defendants did not

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intend to deceive investors, but merely engaged in poor business judgment with respect to Citigroup ARS. Further, reliance was inadequately pled, because — having disclaimed a fraud-on-the-market theory (as the lead plaintiff acknowledged the market was inefficient) — the complaint did not include a basis for why the purported class could rely upon the "integrity" of the auctions. Citigroup's ARS trade confirmations stated that the defendants could intervene in the ARS auctions and that the auctions could fail if the defendants did not intervene, and before the purported class period, Citigroup and the SEC had entered into a publicly available settlement about Citigroup's ARS auction practices. In addition, because the complaint did not allege that the plaintiff tried to sell his ARS or that the defendants' intervening in the auctions resulted in lower interest rates for the ARS, loss causation also was inadequately pled. Finally, the court dismissed the Sections 206 and 215 claims — which related to purported class members' entering into investment advisory contracts with Smith Barney — because the lead plaintiff had not entered into those contracts and did not plead any specific factual allegations identifying a named plaintiff who had done so. Similarly, because the complaint did not specifically identify any named plaintiffs who had purchased Citigroup ARS that were not "covered securities," Judge Swain dismissed the state law breach of fiduciary duty claims as preempted by SLUSA.

SETTLEMENTS

In re Initial Pub. Offering Sec. Litig., No. 21 MC 92 (SAS) (S.D.N.Y. Oct. 5, 2009)

Click here to view the opinion.

S.D.N.Y. Approves Classwide Settlement in Challenge to IPO Underwriters' Practices

Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York approved a classwide settlement in 309 coordinated class actions challenging IPO underwriters' practices with the effect of defrauding the investing public by violating the Securities Act and the Securities Exchange Act. The settlement provided that the defendants would pay $586 million, to be allocated among the 309 coordinated class actions (each class will receive a proportion of the settlement amount, but in no event less than $300,000), and class members receive a *pro rata* share of their class's portion of the $586 million, but no less than $10. Judge Scheindlin explained that none of the lead plaintiffs objected or opted out of the settlement, although five "disapproved" of it (and were replaced by other class members).

Applying the factors in the Second Circuit's *City of Detroit v. Grinnell Corp.* decision, the court determined that the settlement was "fair, reasonable and adequate." First, the litigation had been pending for eight years, with 29 district court opinions, and three court of appeals opinions, with additional discovery and pretrial proceedings still necessary. Second, the class's chance of success at trial was 50 percent at best, and — in any event — a jury might not credit the class' damages theory even if the class were to win a trial. Third, the settlement fund was reasonable in light of the expected recovery and associated risks. Fourth, less than 0.01 percent of the class members objected. Judge Scheindlin noted, however, that the defendants' ability to withstand a greater judgment weighed against approving the settlement. Further, the court determined that the class was properly certified and entitled to a presumption of reliance and awarded PSLRA awards to lead plaintiffs based on what portion of the litigation period they worked. The court also awarded attorneys' fees to class counsel as a percentage of the total settlement after expenses were deducted (which was less than what they would receive under the lodestar method). In addition, Judge Scheindlin noted that reducing the amount of attorneys' fees would "not put more money in class members' pockets" (*e.g.*, reducing the award by $100 million would only give each class member an additional three-tenths of a cent).

SLUSA

Proctor v. Vishay Intertechnology Inc., No. 07-16527 (9th Cir. Oct. 9, 2009)

Click here to view the opinion.

Ninth Circuit Requires Remand, Not Dismissal, of Claims Not Precluded by SLUSA

The U.S. Court of Appeals for the Ninth Circuit, in an opinion authored by Judge Marsha Berzon, held that a district court, upon finding that some (but not all) of plaintiffs' claims are precluded by SLUSA should remand the nonprecluded claims, rather the dismissing the action in its entirety. In the underlying litigation, minority shareholders of Siliconix, Inc. brought a putative class and derivative action against Silconix's majority shareholder, Vishay Intertechnology, Inc. and other related defendants (collectively, Vishay). The district court found that defendants' removal to federal court under SLUSA was proper, but then held that the suit was barred by an injunction issued by a Delaware Court of Chancery and, as a result, could not proceed. The Ninth Circuit affirmed in part, reversed in part and remanded.

As a threshold matter, the court held that it had subject-matter jurisdiction because the lawsuit was SLUSA-removable. In so holding, the court corrected language in prior decisions suggesting that SLUSA preempted state law claims and thus provided an exception to the well-pled complaint rule. The Ninth Circuit explained that, in light of the Supreme Court's decision in *Kircher v. Putnam Funds Trust*, SLUSA does not preempt state law claims, but provides "a federal preclusion defense" and an independent "basis for federal jurisdiction." Having so clarified, the court found that it had jurisdiction under SLUSA because one of plaintiffs' three claims — a class action claim for breach of fiduciary duty — fell within SLUSA's ambit, but its other claims were outside SLUSA's reach. The Ninth Circuit held that, upon finding that one (but not all) of plaintiffs' claims is precluded by SLUSA, the proper course is to remand the nonprecluded claims to state court, and not to dismiss the complaint in its entirety. The court did not definitively decide, however, whether remand needed to be immediate or whether, as in the case at bar, the district court could first consider an injunction entered by another court that purported to prohibit the action from going forward. The Ninth Circuit did not need to resolve the issue because, in any event, it found that the Court of Chancery — which had issued an injunction prohibiting the action from going forward — could not enjoin the California federal action, regardless of its interest in enforcing the purportedly preclusive effect of a settlement between the parties.

Additionally, the court rejected plaintiffs' arguments that the removal notice itself was deficient. The court found defendants timely removed the action because the grounds for removal under SLUSA were not ascertainable until plaintiffs filed their third amended complaint. The Ninth Circuit also found that defendants satisfied the requirement that all defendants join in the removal — the so-called "rule of unanimity." Noting a circuit split on the issue, the Ninth Circuit held that the rule of unanimity was satisfied where one defendant's notice of removal contains an averment that the co-defendants consent to the removal, as opposed to requiring all co-defendants to affirmatively file formal joinders in the removal. Accordingly, the court found that the removal was proper, the SLUSA claim should be dismissed and the nonprecluded claims should be remanded to state court.

Segal v. Fifth Third Bank, N.A., No. 08-3576 (6th Cir. Sept. 17, 2009)

Click here to view the opinion.

Sixth Circuit Affirms Dismissal of Action as Barred by SLUSA

The U.S. Court of Appeals for the Sixth Circuit, in an opinion authored by Judge Jeffrey Sutton, strictly applied SLUSA in affirming the dismissal of a putative class action brought by beneficiaries of fiduciary accounts for which defendant Fifth Third Bank acted as a corporate fiduciary. The complaint alleged that Fifth Third Bank breached its fiduciary duties and contracts by (1) investing fiduciary assets in proprietary (and often higher-fee) Fifth Third mutual funds; (2) falsely promising trust beneficiaries that their accounts would receive "individualized" management; and (3) investing too many of the funds' assets in low-yielding investments. Relying on SLUSA, which prohibits

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individuals from filing class actions involving 50 or more people seeking to vindicate certain state-law securities-related claims, the district court dismissed the action, and the Sixth Circuit affirmed.

The lone issue on appeal was whether the complaint alleged "an untrue statement or omission of material fact" a "manipulative or deceptive device or contrivance" in connection with the purchase or sale of Fifth Third mutual funds, either of which would bring the complaint within SLUSA's reach. The court found that the complaint satisfactorily alleged misstatements, omissions and manipulation, all of which were "in connection with" the sale of Fifth Third mutual funds — a "modest requirement" under the Supreme Court's decision in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*. In so doing, the court rejected plaintiff's argument that SLUSA could not apply because the complaint contained a disclaimer that "[n]one of the causes of action stated herein are based upon any misrepresentation or failure to disclose material facts to plaintiff." In this regard, the court explained that "a claimant can no more elude SLUSA's prohibitions by editing out covered words from the complaint than by disclaiming their presence." Nor was the court moved by plaintiff's argument that SLUSA does not apply because the allegations of misrepresentation and manipulation were purportedly not material to plaintiff's state-law claims. The court held, rejecting contrary *dicta* in a Third Circuit opinion, that "[SLUSA] does not ask whether the complaint makes 'material' or 'dependent' allegations." The court further held that it has "no license to draw a line between SLUSA-covered claims that must be dismissed and SLUSA-covered claims that must not be." Finally, the court similarly rejected plaintiff's argument that SLUSA only precludes claims if the underlying factual allegations would otherwise give rise to an actionable claim under federal securities laws, stating that this interpretation of the law would contradict both SLUSA and *Dabit*. In response to plaintiff's claim that the court's approach would foreclose any remedy toward an unfaithful fiduciary, the Sixth Circuit pointed to the many avenues open to plaintiffs to vindicate their rights, such as by avoiding SLUSA through filing a complaint by fewer than 50 people.

VENUE

Wilson v. Eckhaus, Nos. 08-3751-cv (L), 08-4116-cv (con) (2d Cir. Oct. 21, 2009)

Click here to view the opinion.

Second Circuit Affirms Dismissal of Shareholder Suit Claiming *Forum Non Conveniens* Against Israeli Company

In a *per curiam* summary order signed by the clerk, the U.S. Court of Appeals for the Second Circuit affirmed the district court's dismissal of a shareholder suit alleging, among other things, breach of fiduciary duties, corporate waste, self-dealing, fraud and RICO violations against an Israeli company, ImageSat International, on the ground of *forum non conveniens*. The panel (composed of Judges Joseph M. McLaughlin, Guido Calabresi and Reena Raggi) applied the three-step inquiry in *Iragorri v. United Technologies Corp.*, which requires the court to first determine "the degree of deference" accorded to the plaintiffs' chosen forum, then to determine if the alternative forum is "'adequate'" to resolve the suit, and finally to "balance the private and public interests implicated." As for the first step in the *Iragorri* inquiry, the district court did not abuse its discretion in determining that the plaintiffs' choice to bring suit in the Southern District of New York was accorded "some" deference, because "less than half of the plaintiffs are United States residents," the most relevant evidence was in Israel, and the plaintiffs chose the forum because it was less favorable and convenient to the defendants and allowed them to seek for treble damages under RICO.

The panel additionally rejected the plaintiffs' argument that they also sued for breach of a contract with a New York choice-of-law provision, because that breach was unrelated to the 22 other claims in the complaint or the demanded $5 billion in damages. As for the third step, the panel determined that the totality of the private and public interests made Israel the proper forum. First, the private interests weighed in favor of litigating in Israel, as the evidence existed there. The plaintiffs' claimed reasons for litigating in New York (treble damages under RICO

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are not available in Israel, there "might" be a 2.5 percent filing fee in Israel, defendants' costs were covered by insurance or indemnity agreements, and the plaintiffs' New York counsel was familiar with the case) did not alter that conclusion. Similarly, the public interests weighed in favor of an Israeli forum. ImageSat had a close relationship with the Israeli government (one of its two largest shareholders is wholly owned by the Israeli government), the plaintiffs made claims concerning the Israeli military and foreign policy, and the Israeli Ministry of Defense raised concerns (in a letter to the district court) that the complaint implicated Israel's national security and other governmental interests.

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