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The SEC's New Initiatives Mean Increased Scrutiny for Companies, Including Officers and Directors

By Clifford Thau and Ari M. Berman

The SEC is on the march. Spurred by calls for increased regulation of the financial markets and coming under fire for missing Bernard L. Madoff's Ponzi scheme, the SEC's Division of Enforcement, whose charge includes investigating alleged violations of securities laws at public companies and financial firms, has made clear – in words and through actions – that it will act aggressively as the SEC continues to tighten its oversight of the securities industry and to increase protections for investors in the wake of the financial crisis. Whether the SEC succeeds remains to be seen, but one thing is clear: companies, including their officers and directors, must be even more mindful of their compliance obligations and duties under the securities laws.

The SEC's tone has been set from the top and is being implemented by front-line SEC attorneys, who investigate and bring civil actions involving alleged violations of the securities laws. The SEC's new Director of the Division of Enforcement, Robert Khuzami, is a former prosecutor with the U.S. Attorney's Office for the Southern District of New York and was chief of that office's Securities and Commodities Fraud Task Force. Khuzami has been joined at the top ranks of the SEC by two other former criminal prosecutors — Lorin L. Reisner, the Division of Enforcement's Deputy Director and George S. Canellos, the Regional Director of the SEC's New York Office. Khuzami's appointment, along with the subsequent appointments of Canellos and Reisner, has been viewed as an attempt to increase the SEC's deterrence powers and to restore the Division of Enforcement's reputation as a force against financial misconduct.

Policy speeches by the SEC's new Chairperson, Mary L. Schapiro, and Khuzami have struck a predictably forceful tone, acknowledging a "general sense of renewed urgency" to pursue wrongdoers aggressively. Since assuming his position in early 2009, Khuzami and his staff already have taken concrete steps to improve the Division of Enforcement as the SEC continues to tighten its oversight of the financial markets. Its new initiatives include:

National Specialized Units. The SEC is creating five new specialized units dedicated to particular areas of securities law, each headed by a unit chief and staffed nationally by lawyers and other professionals with the requisite expertise. These include:

- *Asset Management.* Will focus on investment advisors, investment companies, hedge funds, and private equity funds.
- *Municipal Securities and Public Pensions.* Will focus on the growing market for municipal securities, including scrutiny for offering and disclosure issues and "pay-to-play" schemes in which money managers and advisors pay kickbacks in return for the right to advise or receive funds.

Also in this Issue

3 Securities Litigation and the Supreme Court: A Preview of the Court's October 2009 Term

7 Recent Treatment of Loss Causation Across the Circuits

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- *Foreign Corrupt Practices*. Will focus on new and proactive approaches to identifying violations of the Foreign Corrupt Practice Act, which prohibits U.S. companies from bribing foreign officials for government contracts and other business.
- *Market Abuses*. Will focus on large-scale market abuses and complex manipulation schemes by institutional traders, market professionals, and others.
- *Structured and New Products*. Will focus on complex derivatives and financial products, including CDS, CDOs, and securitized products.

Streamline Management to Increase Number of Front-Line Attorneys. The Division of Enforcement is streamlining or "flattening" its management structure to increase the number of front-line attorneys conducting the "heart and sole function of the SEC" — investigating and bringing cases to enforce the securities laws. Khuzami stated that the Division is adding to the ranks of its Trial Unit to convey to defendants that the SEC is prepared to go to trial. He also touted the SEC's recent trial wins, including a jury verdict against K-Mart's former CEO for fraud. As part of the SEC's effort to prosecute cases aggressively, the Division's attorneys will be required to obtain Khuzami's permission to enter into "tolling agreements," in which subjects of inquiries are asked to give investigators more time to look into suspected misconduct than laws typically allow. The SEC has cautioned that such tolling agreements will be the exception, and not the rule, as such agreements compromise the strong desire to have the Division pursue cases quickly.

Issue More Subpoenas. The SEC's new policy is intended to make it easier for its staff to obtain subpoenas by getting approval only from their supervisors, not from the full five-member Commission. These changes are intended to streamline the SEC's investigations and to increase pressure on defendants. As Khuzami stated: "If defense counsel resist the voluntary production of documents or witnesses or fail to be complete and timely in responses or engage in dilatory tactics, there will very likely be a subpoena on your desk the next morning."

New Office to Monitor Tips. The SEC is creating a new Office of Market Intelligence to monitor incoming tips and complaints, encouraging employees and individuals to report potential misconduct to the SEC.

Fostering Cooperation by Individuals. The Enforcement Division will increase incentives to encourage people to testify in SEC cases without fear of criminal prosecution or civil charges. As examples, the SEC is seeking an expedited process to submit immunity requests to the Department of Justice (the SEC is not authorized to grant immunity), as well as a means to provide witnesses with oral assurance that the SEC does not intend to file charges against them.

Increased Resources Devoted to Analytics. In an effort to dispel any notion that it is technically outmatched by sophisticated traders (e.g., hedge funds), the SEC announced that it is devoting more resources to keep pace by increasing its ability to conduct data-intensive surveillance. For example, the SEC is taking a close look at flash quotes, high-frequency trading, and other dark corners of the stock markets, and is enhancing training for its staff and recruiting additional professionals with expertise in trading, portfolio management, valuation, forensic accounting, information security, derivatives and synthetic products, and risk management.

High-Profile Cases and an Emphasis on Pursuing Individuals

The SEC, namely the Khuzami, has gone to significant lengths to publicize that the numbers demonstrate that the Division of Enforcement has been more active. Comparing the period from late January 2009 to September 2009 to the same period in 2008, the SEC has:

- Opened more investigations (1377 compared to 1290);
- Issued more than twice as many formal orders of investigation (335 compared to 143);
- Filed more than twice as many emergency temporary restraining orders (57 compared to 25); and
- Filed more actions overall (458 compared to 359).[1]

Khuzami also has cited the SEC's recent high-profile enforcement cases – which have involved the likes of Bank of America, General Electric, Countrywide Financial's former CEO Angelo Mozilo, and AIG's former Chairman and CEO Maurice "Hank" Greenberg.

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[1] *Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance,* by Robert Khuzami and John Walsh before the United States Senate Committee on Banking, Housing, and Urban Affairs, at 23 (September 10, 2009).

- ***Bank of America.*** United States District Court Judge Rakoff, a judge in New York, made headlines when he threw out the SEC's proposed $33 settlement with Bank of America, which stemmed from Bank of America's allegedly misleading disclosure to shareholders about paying $3.6 billion in bonuses to Merrill Lynch employees upon the company's acquisition. Judge Rakoff characterized the $33 million fine as "strangely askew" given the accusations made, the magnitude of Merrill Lynch's losses, and the government bailout for Bank of America. He also questioned the role of top executives, including Bank of America's CEO Kenneth Lewis and Merrill Lynch's former CEO John Thain, both of whom signed off on a proxy statement to investors. The SEC conceded that while its normal policy in such situations is to go after the company executives who were responsible for the alleged lie, it did not do so here.
- ***General Electric.*** In early August, GE agreed to pay a $50 million penalty to settle the SEC's charges that GE misled investors by reporting materially false and misleading results in its financial statements – *i.e.*, GE used improper accounting methods to increase its reported earnings or revenues and avoid reporting negative financial results.
- ***Countrywide.*** In June, the SEC charged former Countrywide Financial CEO Angelo Mozilo and two other former executives with securities fraud for deliberately misleading investors about the significant credit risks being taken in efforts to build and maintain the company's market share. Mozilo was individually charged with insider trading for selling his Countrywide stock based on non-public information for nearly $140 million in profits.

Despite its reluctance to pursue individual executives in the Bank of America case, the SEC recently has demonstrated its willingness to use all of the tools in its arsenal to hold individuals liable for acts taken by a company. In circumstances where directors are actively involved in the operations of a company, the SEC might decide that there are facts to justify holding that person responsible as a "control person" pursuant to the securities laws.

For example, in August, AIG's Hank Greenberg paid $15 million to settle with the SEC for his involvement in numerous allegedly improper accounting transactions that inflated AIG's reported financial results. The SEC alleged in its complaint that Greenberg (along with AIG's former CFO Howard Smith) was liable as a "control person" for AIG's violations of the antifraud and other provisions of the securities laws. And, in another enforcement action, a settlement involving Nature's Sunshine Products, Inc., the SEC claimed that the company's subsidiary violated the anti-bribery provision of the Foreign Corrupt Practices Act and federal securities laws, and also charged the company's CEO and CFO on the theory that they were in "control" of the primary violator (the company) under the Securities Exchange Act of 1934.

* * *

Overall, the SEC's Division of Enforcement is taking important steps to increase its effectiveness and its leaders have conveyed a clear message that they will ensure that SEC attorneys have the necessary tools and resources to investigate and pursue cases against alleged wrongdoers. Judge Rakoff's skepticism in the Bank of America case whether the SEC is willing to pursue high-ranking individuals will only add fuel to the SEC's desire to prove that it is capable of being an effective "watchdog" of the financial markets. The SEC's renewed commitment to protecting investors, coupled with its admitted determination to avoid the embarrassment of another Madoff scandal, has created an environment of heightened regulatory scrutiny — placing companies and their executives on alert. ■

Securities Litigation and the Supreme Court: A Preview of the Court's October 2009 Term

By Steven R. Paradise and Michelle S. Spak

Since Chief Justice Roberts' appointment, the United States Supreme Court has decided several landmark decisions involving the federal securities laws, especially Rule 10b-5, promulgated under § 10(b) of the Securities Exchange Act of 1934. In 2007, for example, the Court decided *Tellabs v. Makor Issues & Rights*,[2] which clarified the "strong inference" requirement contained in the Private Securities Litigation Reform Act of 1995. By holding that

[2] 551 U.S. 308 (2007).

a complaint alleging violations of Rule 10b-5 will survive a motion to dismiss only "if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged,"[3] *Tellabs* has affected the outcome of motions to dismiss Rule 10b-5 claims, as well as the frequency of nuisance settlements.[4] One year later, in 2008, the Court decided *Stoneridge Investment Partners v. Scientific-Atlanta*,[5] a landmark decision holding that securities-fraud plaintiffs cannot sue third parties, such as accountants, lawyers, financial advisors, and other businesses, unless those third parties issued misleading statements or took direct, deceptive action that the investors relied upon in buying or selling securities.[6]

The October 2009 Term presents the Court with another opportunity to shape the landscape of Rule 10b-5 actions — this time, considering the limitations period for such claims.[7] This case is the focus of this Article. The Court has also elected to hear two other cases that bear on the securities laws: one involving the constitutionality of the Public Company Accounting Oversight Board (PCAOB),[8] and another addressing the standards for evaluating whether the fees of mutual fund advisors are excessive under § 36(b) of the Investment Company Act of 1940.[9] As these cases are less likely to impact securities litigation, we touch upon them only briefly.

3 *Id.* at 324.
4 *See generally* Stephen J. Choi and Adam C. Pritchard, *The Supreme Court's Impact on Securities Class Actions: An Empirical Assessment of Tellabs*, U. Mich. Law & Econ. Olin Working Paper No. 09-016 (August 18, 2009), available at http://ssrn.com/abstract=1457085 (analyzing a sample of securities-fraud class actions filed between 2003 and 2007 and concluding that, after *Tellabs*, circuits that previously followed the "preponderance" standard for pleading scienter — the First, Fourth, Sixth, and Ninth Circuits — are less likely to dismiss a securities-fraud class action on scienter grounds after *Tellabs*, resulting in defendants being more willing to pay a nuisance settlement post-*Tellabs*).
5 552 U.S. 148, 128 S. Ct. 761 (2008).
6 *Id.* at 769, 774.
7 *See Merck & Co. v. Reynolds*, No. 08-905 (cert. granted May 26, 2009).
8 *See Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, No. 08-0861 (cert. granted May 18, 2009).
9 *See Jones v. Harris Assoc., L.P.*, No. 08-586 (cert. granted Mar. 9, 2009). *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991).

***Merck & Co. v. Reynolds*: Inquiry Notice under Rule 10b-5**

Merck represents the first time in nearly 20 years that the Court has considered the statute of limitations for securities-fraud claims. In 1991, the Supreme Court held that Rule 10b-5 claims must be asserted within "one year after the discovery of the facts constituting the violation," but no more than three years after the violation.[10] The Sarbanes-Oxley Act effectively abrogated that decision by extending the limitations period to "two years after the discovery of the facts constituting the violation," but no more than five years after the violation.[11]

Courts agree that "discovery of the facts constituting the violation" does not require actual notice of a violation; rather, "inquiry notice" is sufficient. Lower courts, however, have diverged on what constitutes "inquiry notice."[12] In the Fourth, Fifth, Eighth, and Eleventh Circuits, the limitations period begins running as soon as the plaintiff has notice of the possibility of fraud.[13] In five other circuits — the First, Sixth, Seventh, Ninth, and Tenth — notice of the possibility of fraud obligates an investor to begin investigating, and the limitations period does not begin to run until a person conducting an investigation with reasonable diligence would have uncovered the fraud.[14] Under that standard, a cause of action for securities fraud may not accrue for several years after the investor has notice of the possibility of fraud, especially if the facts necessary to uncover the fraud are difficult for the investor to obtain. The Second Circuit adopted a hybrid approach: the limitations period commences upon notice of the possibility of fraud unless the plaintiff begins an investigation; if the plaintiff investigates the possible

10 *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991).
11 28 U.S.C. § 1658(b).
12 *See Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1199–20 (10th Cir. 1998) (recognizing an inconsistency both within and among the circuits in their determination of exactly when the limitations period accrues).
13 *See Franze v. Equitable Assurance*, 296 F.3d 1250, 1255 (11th Cir. 2002); Great Rivers Coop. of Se. *Iowa v. Farmland Indus., Inc.*, 120 F.3d 893, 898–99 (8th Cir. 1997); *Caviness v. Derand Res. Corp.*, 983 F.2d 1295, 1303 (4th Cir. 1993); *Jensen v. Snellings*, 841 F.2d 600, 607 (5th Cir. 1988).
14 *See Betz*, 504 F.3d at 1024–25 ("Once a plaintiff has inquiry notice, we ask when the investor, in the exercise of reasonable diligence, should have discovered the facts constituting the alleged fraud. The answer to that second question tells us when the statute of limitations begins to run"); *New England Health Care Employees Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 501 (6th Cir. 2003); *Young v. Lepone*, 305 F.3d 1, 9 (1st Cir. 2002); *Sterlin*, 154 F.3d at 1201; and *Marks v. CDW Computer Ctrs., Inc.*, 122 F.3d 363, 368 (7th Cir. 1997).

fraud, the statute of limitations does not begin to run until a reasonable person exercising due diligence would have uncovered the fraud.[15] Based on these different standards, the same claim may be time barred in one jurisdiction but not in another or even time barred for one plaintiff but not for another.

To further complicate matters, the circuits are also split on whether there must be evidence indicating that the defendant acted with the requisite scienter before inquiry notice is triggered. Although most circuit courts have rejected arguments that the statute of limitations does not begin to run until the plaintiff discovers evidence of scienter, the Third and Ninth Circuits recently held that an investor is not placed on inquiry notice until there is publicly available evidence indicating that the defendant's misrepresentations were made with scienter.[16]

These circuit splits take center focus in *Merck*. The *Merck* securities litigation stems from alleged misrepresentations that occurred during Merck's development and sale of Vioxx.[17] Specifically, the plaintiffs allege that Merck made misrepresentations concerning the cardiovascular risks associated with use of Vioxx.[18] In 1999, Merck publicly reported results of a study indicating that use of Vioxx, instead of naproxen, resulted in a lower incidence of gastrointestinal side effects but a higher rate of serious cardiovascular events.[19] Rather than acknowledging that Vioxx increased the rate of blood clots, Merck publicly interpreted the results using a "naproxen hypothesis": naproxen prevented blood clots, protecting people against heart attacks.[20] While Merck was publicly advocating its naproxen hypothesis, news agencies and even manufacturers of naproxen were questioning Merck's hypothesis.[21] In May 2001, users of Vioxx began filing products-liability lawsuits against Merck related to Merck's naproxen hypothesis.[22] In September 2001, the FDA issued Merck a warning letter, published on the FDA's website, concerning Merck's selective presentation of the results.[23] Prominent newspapers reported the FDA's action, resulting in a 6.6 percent drop in Merck's stock price.[24] A few weeks later, *The New York Times* published a second article in which the president of Merck Research Laboratories revealed the two possible interpretations for the results of the earlier Vioxx study: "Naproxen lowers the heart attack rate or Vioxx raises it."[25] Despite this flurry of activity culminating on October 9, 2001, the securities-fraud plaintiffs did not file their lawsuit until November 6, 2003.[26]

Citing the above-mentioned facts, the district court determined that "storm warnings" of the possibility that Merck misrepresented the effects of Vioxx existed by October 9, 2001 — the date the president of Merck Research Laboratories admitted the other possible interpretation of the Vioxx test results.[27] Thus, because the investors did not conduct an investigation into the possible fraud, the district court held that the limitations period began to run, under Third Circuit precedent, on October 9, 2001, and expired two years later on October 9, 2003.[28]

Despite stating the same test as had been used previously,[29] the Third Circuit applied this test in a previously unseen manner. The court declared that "to trigger 'storm warnings of culpable activity,' in the context of a claim alleging falsely-held opinions or beliefs, investors must have sufficient information to suspect that the defendants engaged in culpable activity."[30] By this statement, the Third Circuit held that the statute of limitations does not begin to run until the plaintiff not only learns about the possibility that a misrepresentation

[15] *See LC Capital Partners, LP v. Frontier Ins. Group*, 318 F.3d 148, 154 (2d Cir. 2003). Before the decision in *Merck*, the Third Circuit also utilized this approach. *See Mathews v. Kidder, Peabody & Co.*, 260 F.3d 239, 252 (3d Cir. 2001).

[16] *See Betz v. Trainer Wortham*, 519 F.3d 863, 867–68 (9th Cir. 2008) (Kozinski, C.J., dissenting from denial of rehearing en banc) ("The panel cites no authority supporting its curious notion that an investor isn't on inquiry notice until he has concrete proof of every element of his claim, including scienter. There is no such authority; ten circuits disagree"). The Ninth Circuit was joined by the Third Circuit when the Third Circuit issued its opinion in *Merck. In re Merck & Co. Sec., Derivative & "ERISA" Litig.*, 543 F.3d 150, 166 (3d Cir. 2008) ("[t]o trigger 'storm warnings of culpable activity,' in the context of a claim alleging falsely-held opinions or beliefs, investors must have sufficient information to suspect that the defendants engaged in culpable activity, i.e., that they did not hold those opinions or beliefs in earnest").

[17] *Merck & Co. v. Reynolds*, Petition for a Writ of Certiorari, 2009 WL 133458, at *6–7 (Jan 15, 2009).

[18] *Id.*

[19] *Id.* at *7.

[20] *Id.*

[21] *Id.* at *8.

[22] *Id.* at *10.

[23] *Id.* at *8.

[24] *Id.* at *9–10.

[25] *Id.* at *10.

[26] *Id.* at *11.

[27] *In re Merck & Co. Sec., Derivative, & "ERISA" Litig.*, 483 F. Supp. 2d 407, 424 (D.N.J. 2007). Indeed, the district court explained that "the torrent of publicity discussed above is more akin to thunder, lightning and pouring rain than subtle warnings of a coming storm." *Id.* at 423.

[28] *Id.* at 424.

[29] *In re Merck & Co. Sec., Derivative, & "ERISA" Litig.*, 543 F.3d 150, 162 (3d Cir. 2008).

[30] *Id.* at 166.

was made, but also that the speaker knew or should have known that the representation was false. And, the Third Circuit commingled materiality, efficient market theory, and loss causation with inquiry notice, looking for a movement in the stock price before finding that "storm warnings" existed.[31] Underlying the Third Circuit's holding was a fear that under the heightened pleading standards of the PSLRA, finding the statute of limitations period to have run before a plaintiff could discover evidence of scienter may result in plaintiffs being forced to bring securities-fraud actions prematurely and those lawsuits being dismissed at the pleadings stage.[32]

Having granted *certiorari* in *Merck*, the Supreme Court now has the opportunity to establish a nationwide standard for determining at what point inquiry notice arises. Is information suggesting the possibility of fraud sufficient? Or, must there be publicly available information demonstrating that the defendant had knowledge that the misrepresentations were false? Is the limitations period tolled for a plaintiff because that plaintiff decides to investigate the claim?

This case has wide-ranging implications for securities-fraud claims. If the Court takes a position similar to that of the Fourth, Fifth, Eighth, and Eleventh Circuits — inquiry notice arises when the plaintiff has notice of the possibility of fraud, not scienter, regardless when a reasonable investigation would have uncovered the fraud — it may become more difficult for plaintiffs to survive motions to dismiss based on the heightened pleading requirements of the PSLRA. A decision affirming the Third Circuit, in contrast, could effectively nullify the discovery portion of the limitations period, making the "statute of limitations" nothing more than a statute of repose, which prohibits claims from being asserted more than five years after the alleged misrepresentation — regardless of injury.

31 *Id.* at 168, 172; *id.* at 177 (Roth, J., dissenting) (rejecting majority opinion's conclusion and explaining that "fluctuations in stock price and analysts' ratings and projections, although relevant, are *not* a *required* consideration in this circuit's objective 'storm warnings' analysis").

32 *Id.* at 164–65.

Free Enterprise Fund v. PCAOB: The Constitutionality of the PCAOB

Although the issues presented in *Free Enterprise Fund* do not involve securities litigation directly, the case could invalidate the PCAOB on constitutional grounds — a decision that would impact every public company. The plaintiff in *Free Enterprise Fund* is raising a facial challenge to the PCAOB, namely that the manner in which PCAOB members are appointed and removed violates the Appointments Clause and separation-of-powers principles.[33] Both the district and appellate courts determined that the PCAOB's structure is constitutional. Based largely on a vigorous dissent by Judge Kavanaugh of the D.C. Circuit,[34] the Supreme Court has granted *certiorari* to consider the issue.

Assuming Congress does not remedy the constitutional defects perceived by Judge Kavanaugh,[35] the Supreme Court will take on the question of whether the Sarbanes-Oxley Act's creation of the PCAOB is constitutional. The impression among many scholars is that the originalist-leaning Supreme Court is likely to reverse the D.C. Circuit's opinion.[36] Should that happen, Congress will have many options to modify the structure of the PCAOB so that it becomes a constitutional agency. Accordingly, the Supreme Court's decision in *Free Enterprise Fund* likely will be interesting and relevant to the development of constitutional law, but have little effect on the business community or accounting regulations.

33 *Free Enter. Fund*, 537 F.3d at 669.

34 *See* Michael R. Keefe, Note, *The Constitutionality of the Double For-Cause Removal Restriction: Free Enterprise Fund v. Public Company Accounting Oversight Board*, 537 F.3d 667 (D.C. Cir. 2008), 77 U. CIN. L. REV. 1653, 1666–67 (2009) (describing Judge Kavanaugh's originalist approach).

35 *See id.* at 688 (noting that "the constitutional flaws here could be easily and quickly corrected").

36 *See, e.g.*, Keefe, *supra* note 33, at 1678–82; Julian Helisek, *The Fault, Dear PCAOB, Lies Not in the Appointments Clause, But in the Removal Power, That You Are Unconstitutional*, 77 GEO. WASH. L. REV. 1063, 1065 (2009) (noting that "Judge Kavanaugh's position likely will prevail when the Supreme Court decides the case"), Chad N. Eckhardt, Note, Free Enterprise Fund v. Public Company Accounting Oversight Board]: *The Decision that Corporate America May Forever Be Waiting For*, 36 N. KY. L. REV. 143, 154 (2009) (concluding that the removal provision is unconstitutional); Recent Case, *Administrative Law – Appointments Clause – D.C Circuit Holds that the SEC Chairman Is Not the "Head" of the SEC – Free Enterprise Fund v. Public Co. Accounting Oversight Board*, 537 F.3d 667 (D.C. Cir. 2008), Cert. Granted, 77 U.S.L.W. 3431 (U.S. May 18, 2009) (No. 08-861), 122 HARV. L. REV. 2267, 2274 (2009).

Jones v. Harris Associates, L.P.: Measuring Whether Mutual Fund Advisor Fees Are Excessive

Jones presents the narrow question of how a court should determine whether a mutual fund advisor's fees are excessive under § 36(b) of the Investment Company Act of 1940.[37] For over 25 years, whether a mutual fund advisor's fee is excessive has depended upon "whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in light of all the surrounding circumstances."[38] Despite this longstanding rule, a panel of the Seventh Circuit, in an opinion written by Chief Judge Easterbrook (who is known for applying economic considerations to the court's jurisprudence), rejected judicial determination of the reasonableness of fees, in favor of reviewing fees in reference to the advisor's fiduciary duty, including the duty of full disclosure.[39] *Jones* presents the Supreme Court with an opportunity to affirm or reject this long-standing rule. ■

Recent Treatment of Loss Causation Across the Circuits

By Kenneth P. Held, Michael V. Rella, and Elizabeth C. Brandon

The significance of the United States Supreme Court's landmark decision in *Dura Pharmaceuticals, Inc. v. Broudo*[40] addressing loss causation cannot be overstated; the decision has been cited nearly 2,800 times in other decisions and articles in less than five years. While *Dura* made clear that plaintiffs bringing securities actions must show "a causal connection between the material misrepresentation and the loss,"[41] it provided little guidance as to *how* plaintiffs can satisfy this requirement. To fill this gap, circuit courts have developed varying approaches for establishing loss causation in different stages of litigation, including the pleading stage and on motions for summary judgment and class certification.[42]

The questions left unanswered by *Dura*, and which the circuit courts are now addressing include:

- How closely must the disclosure that reveals the untruth of the prior alleged misrepresentation or omission (the "corrective disclosure") match the prior alleged misrepresentation or omission?
- What pleading standard applies at the motion to dismiss stage?
- What burden of proof applies at the summary judgment stage, and what must plaintiffs do to meet its burden of proof?
- What burden of proof applies at the class certification stage, and what showing of loss causation must plaintiffs make to demonstrate that the fraud-on-the-market presumption of reliance applies to certify a class?

Establishing loss causation remains a significant hurdle for securities fraud plaintiffs, and *Dura* and its circuit court progeny provide significant defenses to such actions.

Second Circuit

In *Lentell v. Merrill Lynch & Co.*,[43] decided pre-*Dura*, the Second Circuit affirmed the dismissal of an action seeking losses for investments in Internet stocks based on research reports that, while objectively accurate, did not reveal the authors' actual subjective beliefs. The court held that plaintiffs failed to allege that the defendants' fraudulent statements, as opposed to market factors that were prevalent across the industry, caused the actual loss and that the alleged fraud – the omitted subjective beliefs – were ever revealed to the market.[44]

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[37] 15 U.S.C. § 80a-35.

[38] *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923, 928 (2d Cir. 1982).

[39] *Id.* at 632–33.

[40] 544 U.S. 336 (2005).

[41] *Id.* at 342.

[42] While this article focuses on recent loss causation decisions from circuit courts where securities fraud actions are prevalent, other circuit courts have also recently addressed loss causation. *See McKowan Lowe & Co. v. Jasmine, Ltd.*, 231 Fed. Appx. 216 (3d Cir. 2007) (affirming district court's order granting defendants' motion for summary judgment and holding that plaintiffs failed to show that there were any disclosures to the market that revealed the truth that was allegedly concealed by defendants' misstatements or omissions); *McCabe v. Ernst & Young LLP*, 494 F.3d 418 (3d Cir. 2007) (affirming summary judgment for the defendant and holding that plaintiff failed to show that "the defendant misrepresented or omitted the very facts that were a substantial factor in causing the plaintiff's economic loss"); *Teachers Retirement System of Louisiana v. Hunter*, 477 F.3d 162, 187 (4th Cir. 2007) (affirming district court's dismissal and holding that loss causation should be pled with "sufficient specificity to enable the court to evaluate whether the necessary causal link exists"); *In re Mutual Funds Invest. Litigation*, 566 F.3d 111, 119 (4th Cir. 2009) (reversing dismissal and holding that loss causation must be pled with particularity under Rule 9(b)); *D.E. & J. Limited Partnership v. Conaway*, 133 F. Appx 994 (6th Cir. 2005) (affirming district court's dismissal and holding that plaintiff "has done nothing more than note that a stock price dropped after a bankruptcy announcement, never alleging that the market's acknowledgement of prior misrepresentations caused the drop.")

[43] 396 F.3d 161 (2d Cir. 2005).

[44] *Id.* at 174.

Post-*Dura*, the Second Circuit continued to require plaintiffs to plead that defendant's alleged misstatements directly caused the plaintiff's loss. In *Lattanzio v. Deloitte & Touche LLP*,[45] plaintiffs alleged that the defendant, an independent auditor, was liable for misstatements that were contained in a company's financial statements that were issued before the company declared bankruptcy. The Second Circuit affirmed the district court's dismissal, concluding that plaintiffs failed to plead loss causation because they did not allege that defendant's purported misstatements concealed the risk of the company's bankruptcy.

Accordingly, the Second Circuit requires a close causal connection between the defendant's alleged misstatements and the plaintiff's purported loss, and the plaintiff must take into account other factors that may be responsible for the drop of the defendant's share price.

Fifth Circuit

In a trilogy of recent decisions addressing loss causation, the Fifth Circuit clarified that a securities fraud complaint must sufficiently link the stock price drop to the disclosure of some "relevant truth" regarding the alleged fraud.

In *Lormand v. US Unwired, Inc.*,[46] the Fifth Circuit reversed the district court's granting of a motion to dismiss a Rule 10b-5 class action complaint. The decision addressed two primary issues: (i) what is the appropriate pleading standard for loss causation in a securities fraud class action, and (ii) what relationship between the alleged corrective disclosure and the alleged fraud is needed to constitute "relevant truth" under *Dura*. The Fifth Circuit rejected the Fourth Circuit's holding that the heightened pleading standard of Rule 9(b) applied to pleading loss causation; instead, the Fifth Circuit held that loss causation was subject to the ordinary pleading standard under Rule 8(a).[47] A complaint must simply allege "a facially 'plausible' causal relationship between the fraudulent statements or omissions and plaintiff's economic loss, including allegations of a material misrepresentation or omission, followed by the leaking out of relevant or related truth about the fraud that caused a significant part of the depreciation of the stock and plaintiff's economic loss."[48]

On the relationship between disclosure and alleged fraud, the court borrowed from the definition of relevance found in the Federal Rules of Evidence, stating "the truth disclosed must simply make the existence of the actionable fraud more probable than it would be without that alleged fact (taken as true)."[49] Applying these standards, the court held that while some of the alleged disclosures sufficiently related to certain of the alleged omissions, others did not, and thus, the court reversed in part and affirmed in part the district court's dismissal.[50]

In *Alaska Electrical Pension Fund v. Flowserve Corporation*,[51] plaintiff appealed the district court's denial of class certification and entry of summary judgment for defendants. The decision, a *per curiam* opinion, with Justice O'Connor sitting on the panel by designation, addressed two primary issues: (1) what is plaintiff's burden of proof to demonstrate loss causation to certify a class; must a plaintiff demonstrate loss causation by a preponderance of the evidence, or merely demonstrate that a reasonable jury could find loss causation by a preponderance of the evidence, and (2) under the applicable burden of proof, what type of evidence is sufficient to prove loss causation.[52] On the first issue, the court reiterated prior Fifth Circuit precedent and held that Rule 23 requires plaintiffs to demonstrate loss causation by a preponderance of the evidence at the class certification stage. The court acknowledged that this is a higher burden of proof than that required to defeat a motion for summary judgment under Rule 56.[53] With respect to the issue of what evidence is sufficient to demonstrate loss causation, the defendants had argued for a "fact-for-fact" disclosure standard. The district court had adopted this approach and required that the "corrective disclosure" specifically reveal the alleged fraud. The Fifth Circuit disagreed and reversed, holding that *Dura* does not require such a direct relationship.[54] The opinion reasoned that a "fact-for-fact" standard would do away with the fraud-on-the-market theory of reliance. "[I]f a 'complete' corrective disclosure were required, defendants could 'immunize themselves with a protracted series

45 476 F.3d 147 (2d Cir. 2007).
46 565 F.3d 228 (5th Cir. 2009).
47 *Id.* at 258.
48 *Id.*

49 *Id.* at 256, n. 20.
50 *Id.* at 262-67.
51 572 F.3d 221 (5th Cir. 2009) (*per curiam*) (O'Connor, J., sitting by designation).
52 *Id.* at 228-32.
53 *Id.* at 228-29.
54 *Id.* at 229-31.

of partial disclosures.'"[55] Citing *Lormand*, the court found that a plaintiff must prove that subsequent disclosures concern the same subject matter as the alleged fraud.

Finally, in *Fener v. Belo Corporation*,[56] plaintiffs appealed the district court's denial of class certification, arguing that the corrective disclosure was one of several facts disclosed in defendant's press release.[57] Plaintiffs' expert treated the press release as an isolated disclosure and submitted an event study demonstrating how the release caused the stock price to drop. The Fifth Circuit found this approach improper, holding that where the alleged corrective disclosure was one of multiple disclosures contained in a single document, the plaintiff must isolate the corrective disclosure and its impact on the stock price.[58] The court affirmed the denial of class certification.

In synthesizing these three decisions, the Fifth Circuit has provided plaintiffs with some helpful guidelines: (1) plaintiffs' loss causation allegations are not subject to Rule 9(b)'s heightened pleading requirements, although they still must allege facts that demonstrate corrective disclosures revealed the relevant truth and made the actionable fraud probable to avoid dismissal; (2) plaintiffs must demonstrate loss causation by a preponderance of the evidence at the class certification stage; (3) while corrective disclosures need not reveal the alleged fraud "fact-for-fact," their subject matter must have a sufficient relationship to the subject matter of the alleged fraud; and (4) plaintiffs must isolate corrective disclosures from other disclosures made at the same time, and show the corrective disclosures' impact on the stock price.

Seventh Circuit

The Seventh Circuit addressed the fraud-on-the-market theory of pleading loss causation in *Tricontinental Industries, LLC v. PricewaterhouseCoopers, LLC*.[59] Plaintiff alleged that after they purchased a company's securities in reliance on its financial statements, the company announced an investigation of possible accounting irregularities that caused the company's stock price to drop. In affirming dismissal, the Seventh Circuit held that plaintiff's allegations were insufficient to plead loss causation because plaintiff failed to identify any statement that made "generally known" any problems or irregularities in the financial statements.[60]

The court revisited the issue four months later in a similar decision, which set a very stringent test for plaintiffs attempting to satisfy *Dura's* loss causation test. In *Ray v. Citigroup Global Markets, Inc.*, the Seventh Circuit outlined three approaches to proving loss causation: (1) materialization of risk, (2) "fraud-on-the-market," and (3) the risk-free assurance by the defendant.[61] The court affirmed the district court's grant of summary judgment, holding that plaintiffs failed to demonstrate loss causation under any of the three approaches because they did not dispense with defendants' other explanations for the alleged loss through experts.[62]

Collectively, these cases provide that plaintiffs must plead facts showing that corrective disclosures made the defendant's alleged misstatements "generally known," and on motions for summary judgment, plaintiffs must admit evidence dispensing of other explanations for the alleged drop in the defendant's share price.

Ninth Circuit

In two decisions that were issued within two weeks of each other, the Ninth Circuit reached different conclusions in addressing plaintiffs' loss causation arguments. In *Corinthian Colleges*,[63] plaintiff alleged that defendant manipulated student enrollment figures to receive federal funding that it reported as income. When this practice was disclosed, the defendant announced that it was adjusting its revenue forecast, which caused the company's stock price to decline. In affirming the district court's dismissal, the Ninth Circuit held that the complaint did not allege that the announcements disclosed "the fraudulent activity that [plaintiff] contend[ed] forced down the stock that caused its losses."[64]

Conversely, in *In re Gilead Sciences Sec. Litig.*,[65] the Ninth Circuit reversed the district court's dismissal, and held that a more than three-month temporal gap between

55 *Id.* at 230.
56 ___F.3d___, 2009 WL 2450674 (5th Cir. Aug. 12, 2009).
57 *Id.* at *2.
58 *Id.* at *5-7.
59 475 F.3d 824 (7th Cir. 2007).
60 *Id.* at 843.
61 482 F.3d 991, 995-96 (7th Cir. 2007).
62 *Id.*
63 540 F. 3d 1049 (9th Cir. 2008).
64 *Id.* at 1063.
65 536 F.3d 1049 (9th Cir. 2008), cert. denied, 129 S.Ct. 1993 (2009).

the time the alleged misrepresentation was revealed and the later decline in stock price did not render plaintiff's theory of loss causation implausible.[66] The court went on to note that loss causation is more important at trial than at the pleading stage.[67]

While these two decisions appear to be at odds, they provide guidance to plaintiffs by directing them to plead facts closely linking the defendant's alleged misstatements to the drop in share price, regardless of whether the alleged disclosure occurred several months before the decrease in the defendant's share price.

Tenth Circuit

The Tenth Circuit also raised the bar for plaintiffs attempting to show loss causation in its recent decision in *In re Williams Securities Litigation*.[68] After representing that spinning-off one of its telecommunications companies was the best way to ensure the success of both companies, the telecommunications company tumbled into bankruptcy. Plaintiffs offered two theories of loss causation through their expert: (1) a leakage theory, whereby plaintiffs alleged that the fraud materialized through a series of leaks; and (2) a corrective disclosure theory, whereby plaintiffs alleged that the fraud was revealed via four public disclosures.[69] The Tenth Circuit rejected both theories and affirmed the lower court's decision excluding plaintiffs' proffered expert testimony and granting defendants' motion for summary judgment. The court stated that plaintiffs failed to demonstrate how the truth emerged, and failed to make any real effort to sort out other possible events that may have impacted the price. The court also noted that a corrective disclosure must at least relate back to the misrepresentation and not to some other negative information about the company, *i.e.*, the disclosure must be "within the zone of risk concealed by the misrepresentations and omission" claimed by plaintiffs.[70]

* * *

Since *Dura* mandated that plaintiffs are required to show loss causation, several circuit courts have issued decisions prescribing different methods and standards for satisfying this requirement. While the standards vary from court to court, plaintiffs' securities fraud claims will be subject to dismissal if plaintiffs fail to plead adequate facts (or present adequate evidence on motions for class certification or summary judgment) closely linking the alleged misstatement with the defendant's drop in share price, taking into account outside factors that may be responsible for the purported drop. ■

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66 *Id.* at 1058.
67 *Id.* at 1057.
68 558 F.3d 1130 (10th Cir. 2009).
69 *Id.* at 1137-43.
70 *Id.* at 1140-43.

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