

Class Certification in Securities Litigation – The New Tipping Point

By Steven R. Paradise and Hilary L. Preston

With the heightened pleading standards imposed by the Private Securities Litigation Reform Act (PSLRA) and the attention given to pleading standards by the Supreme Court and the Court of Appeals,¹ many litigants began to view the motion to dismiss stage as the tipping point in a securities fraud class action lawsuit. That is, if a case proceeds past a motion to dismiss, the automatic discovery stay imposed by the PSLRA lifts and the costs rapidly mount for the defense. As a result, the pressure to settle can intensify. But with many courts now willing to bifurcate class and merits discovery, this pressure can be alleviated until after the court's consideration of whether the case can proceed as a class action. The class certification motion – which some largely considered a *fait accompli* in securities fraud suits after the Supreme Court endorsed the fraud-on-the market presumption of reliance in *Basic v. Levinson*² – is again becoming a rigorous and increasingly challenging burden for plaintiffs. Courts of Appeals are reversing trial courts for failing to conduct the probing review Rule 23 requires. We outline below certain bases upon which defendants have had success in opposing class certification in securities fraud suits. We also discuss the opportunity for defendants to challenge preemptively class certification in appropriate cases, rather than waiting to respond to a plaintiff's motion for class certification.

¹ E.g., *Tellabs, Inc. v. Makor Issues & Rights, Inc.*, 551 U.S. 308 (2007).

² 485 U.S. 224 (1988).

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Adequacy

This element of Rule 23(a) of the Federal Rules of Civil Procedure requires that the class representative fairly and adequately protect the interests of the class. FED. R. CIV. P. 23(a). Folded into this analysis is a review of both the proposed class representative and its counsel, and – in perhaps one of the most interesting hot button adequacy issues – the relationship between the proposed representative and its counsel.³ Because one of the main purposes of the PSLRA was Congress's desire to curb "abusive, lawyer driven litigation,"⁴ the circumstances behind how a plaintiff came to serve as a lead plaintiff and proposed class representative are fair game for class discovery.

Defense counsel should probe not only the typical adequacy topics such as the proposed representative's knowledge of the allegations and the evidence supporting these allegations, but also any facts tending to show that the plaintiff was "recruited" into the case by class counsel. The PSLRA was designed to ensure that the "plaintiff will choose counsel rather than . . .

³ See *Stirman v. Exxon Corp.*, 280 F.3d 554, 563 (5th Cir. 2002).

⁴ *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S.Ct. 1503, 1510-11 (2006).

counsel choosing the plaintiff,” see H.R. CONF. REP. NO. 104 369, at 35. Accordingly, defense counsel should probe the timing of plaintiff’s awareness of the suit or the facts giving rise to the suit and the timing of the engagement of counsel. Defendants should also seek the production of any engagement letters and “portfolio monitoring agreements.” The latter – which are agreements between class action law firms and institutional investors that give counsel access to the investor’s portfolios for the purpose of monitoring any “unusual activity,” (*i.e.*, large stock price drops) that can give rise to a securities fraud claim and the filing of a lawsuit – have recently come under fire as potentially posing conflicts of interest for the class action firms.⁵

For purposes of class certification, these agreements may be most relevant as they raise the possibility that the lawsuit is driven by plaintiff’s counsel, instead of plaintiff, in contrast to the PSLRA’s goals. “The adequacy standard must reflect the governing principles of the [PSLRA] and, particularly, Congress’s emphatic command that competent plaintiffs, rather than lawyers, direct such cases.”⁶ If it can be shown that the proposed class representative was unaware of the facts underlying the suit, or perhaps even of its investment in the securities at issue, until class counsel advised it of the possibility of the suit, then there is a strong argument that the PSLRA’s mandate against lawyer-driven litigation is being thwarted and the proposed class representative and its counsel are inadequate representatives for the class.

Predominance

This element of Rule 23(b) requires that common issues of law and fact predominate over individual issues. This is the means by which loss causation (*i.e.*, the requirement that there be “a causal connection between the material misrepresentation and the loss,”⁷) is tested at the class certification stage. A brief explanation may help to clarify why loss causation must be considered as part of the class certification analysis.

⁵ See *e.g.*, Transcript of Proceedings, April 1, 2009, *Iron Workers Local 25 Pension v. Credit Based Asset Servicing*, No. 08-cv-10841 (S.D.N.Y.), at 9 (Judge Rakoff commenting that portfolio monitoring agreements were “about as obvious an instance of conflict of interest as I’ve ever encountered in my life”).

⁶ *Berger v. Compaq Computer Corp.*, 257 F.3d 475, 484 (5th Cir. 2001).

⁷ *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005).

One of the elements of a securities fraud suit is reliance, and whether a particular class member relied on a particular misrepresentation is a classically individualized inquiry that could predominate over class-wide inquiries and prevent class certification in securities fraud suits. But in *Basic v. Levinson*, the Supreme Court endorsed the theory of a fraud-on-the-market presumption of reliance, which presumes that investors rely on the integrity of a stock’s market price when purchasing stock and posits that the stock’s market price reflects all publicly available information about the stock if it trades in an efficient market.⁸ To demonstrate that the market is efficient such that the presumption can attach, the plaintiff must show either that the stock price increased following the alleged misrepresentation (hence showing the artificial inflation in the stock price) or that the stock price decreased following the corrective disclosure (hence showing the removal of the artificial inflation).⁹ Thus, at the class certification stage, a plaintiff must show loss causation by a preponderance of the evidence.¹⁰

One issue that has become challenging for parties and the courts is how to assess loss causation when a disclosure involves more than one piece of corrective information, some of which is wholly unrelated to the alleged fraud. How do the parties and the courts untangle the effects of the various pieces of information simultaneously available to the market? The Fifth Circuit has not answered the question of how it can be done, but has imposed a clear mandate that it be done – requiring that when multiple pieces of information are released at once, the plaintiff must prove, at the class certification stage, that “the cause of the decline in price is due to the revelation of the truth and not the release of . . . unrelated negative information.”¹¹ Defense counsel should be attuned to this issue and closely scrutinize whether the plaintiff has provided sufficient evidence of the effect of one disclosure versus another.

⁸ *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988).

⁹ *Greenberg*, 364 F.3d at 665-66.

¹⁰ *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 266 (5th Cir. 2007).

¹¹ *Oscar*, 487 F.3d at 265; see also *Fener v. Belo Corp.*, No. 08-20576, 2009 WL 2450674 (5th Cir. Aug. 12, 2009) (requiring that the plaintiff isolate the effect of the relevant information on the stock price).

Preemptively Challenging Class Certification

The normal course for raising class certification issues in securities fraud cases is for defendants to wait until a plaintiff makes a motion for class certification, and then oppose it. But there is nothing that prevents a defendant from preemptively challenging class certification in appropriate cases. Rule 23 mandates that a court must evaluate class certification at “any early practicable time after a person sues . . . as a class representative.” FED. R. CIV. P. 23. “In some instances, the propriety *vel non* of class certification can be gleaned from the face of the pleadings.”¹² If that is the case, then a motion to strike class allegations can be brought simultaneously with a motion to dismiss.

More often, however, some discovery is usually needed to assess the propriety of class certification in securities fraud cases. In those cases, a motion to deny class certification can be brought, but likely only after some class and expert discovery have taken place. If a defendant assesses the case at an early stage and determines that it has a strong challenge to class certification, it may make sense to consent to a partial lift of the automatic discovery stay such that the motion to deny class certification could be brought even before resolution of the motion to dismiss. Obviously, a defendant should weigh the likelihood of succeeding on such a motion against the additional cost that would be incurred. In most instances, however, a preemptive motion to deny class certification makes sense only if a court has denied a defendant’s motion to bifurcate discovery. In that circumstance, the defendant may be facing burdensome merits discovery and would prefer to obtain a ruling on the issue of class certification. This will clarify the scale of the case going forward, before the defendant is required to complete and bear the burden of full merits discovery.

Conclusion

A denial of class certification, while technically not a final disposition of the case, can in practice have the same effect. It is generally not economical for a plaintiff’s firm taking the case on contingency to continue prosecuting an individual, as opposed to class, action, and thus a denial of class certification can quickly lead to an inexpensive

settlement. Given that and many courts’ renewed interest in conducting a rigorous analysis of Rule 23’s requirements in securities fraud suits, defense counsel is well advised to ensure that adequate resources and analysis are devoted to this stage of the case. ■

Securities Class Actions and Life Sciences Companies

By David R. Woodcock, Jr. and Christina L. Stanland

Life sciences companies are frequent targets of securities class actions. There likely are many reasons for this, including the fact that these companies are often characterized by uncertainty in terms of product development and viability, occasional volatile stock prices, a need for lengthy testing and government approval processes for their products, young management teams, and products with enormous potential for future revenue generation but serious risk of failure to come to market.

Some practical aspects of securities class actions make it unlike many other kinds of litigation faced by life sciences companies. First, securities class actions almost always involve claims that high level corporate officers and directors committed fraud and enriched themselves at the expense of shareholders. For young companies trying to build their reputations in the market, like many life sciences companies are, such allegations can impede growth because with an unproven product history, the companies often rely heavily on their managements’ reputations. Second, the types of allegations usually present in securities class actions can impact a company’s ability to borrow, engage in corporate deals, and otherwise fully access the credit and equity markets. Third, securities class actions are expensive to litigate and to settle. It can cost tens of millions of dollars to defend even meritless claims if they survive a motion to dismiss due in large part to high cost of electronic and other discovery, including depositions. Moreover, if summary judgment is denied after discovery, the cost of settlement rises even higher. And the *average* settlement value for securities class actions since 1996 has ranged from \$8 million in 1996 to a high of \$80 million in 2006. Removing some one-off smaller cases from the data, in 2009, the average settlement value was \$42

¹² *Mills v. Foremost Ins. Co.*, 511 F.3d 1300, 1309 (11th Cir. 2008).

million.¹³ In 2009, the *median* settlement was \$9 million, which was similar to the median settlements from 2007 and 2008.¹⁴ Finally, securities class actions can take a long time to resolve and rarely go to trial. For class actions filed from 1996 - 2006 and resolved by the end of 2009, the median time to resolution was 31 months, with a median time to settlement of 36 months and a median time to dismissal of 23 months.¹⁵

This article briefly discusses securities class action claims against life sciences companies and some of the things a company can do to prepare for such litigation.

Securities Class Actions Against Life Sciences Companies

Securities litigation against life sciences companies have remained fairly steady – around 10 - 12 percent of total securities class actions filed over the past few years. Overall in 2009, there were 17 securities class actions filed against life sciences companies, or approximately 10 percent of all securities class actions.¹⁶ In 2008, there were 23 new securities class actions filed against life sciences companies, or approximately 10 percent of the total 226 new lawsuits that year, compared to 21 securities class actions, or 12 percent, filed against life sciences companies in 2007.¹⁷ This steady supply of cases is due, in part, to a sophisticated plaintiffs' class action bar that has become equipped to understand and track disclosure and financial issues in the life sciences industry.

In 2009, most allegations against life sciences companies fell into three categories: (1) claims related to the status of drug or device approval, trials, and

FDA actions; (2) claims related to financial issues or business operations (not specifically tied to drug or device approvals); and (3) claims related to acquisitions or tender offers.¹⁸ At a more granular level, common allegations concern misrepresented results or progress on clinical trials, financial misstatements or improperly recognized revenue, disclosures about product commercial viability or ultimate efficacy, manufacturing deficiency or controls, merger integration issues, and issues with the company's intellectual property.

Reviewing the allegations from complaints filed in 2009, defendants are alleged to have engaged in the following violations of the securities laws:

- Concealing serious issues at two of the company's manufacturing facilities which caused shortages in the company's top-selling product and delayed formulation of another product, as well as halting production of two other top-selling products because of contamination.
- Misleading investors regarding the status of a new drug application (NDA) with the FDA and failing to disclose that the FDA had requested several reports from the company before the NDA could be considered, thus delaying approval of drug.
- Failing to reveal serious customer complaints regarding its over-the-counter (OTC) product and failing to submit reports to the FDA as required.
- Failing to disclose the known possibility that the reimbursement rate for Medicare would be reduced, leading to lower revenues in the future.
- Failing to disclose an FDA-issued "approvable letter" indicating that the NDA was approvable, subject to satisfying concerns about the safety and efficacy. This was contrary to previous statements that the drug was "virtually guaranteed" to be approved.
- Issuing false and misleading statements regarding the company's failure to meet the FDA's current Good Manufacturing Practice, failing to take

¹³ Stephanie Plancich, Ph.D. and Svetlana Sarykh, *Recent Trends in Securities Class Action: 2009 Year-End Update*, at 14 NERA Economic Consulting (December 19, 2009), available at http://nera.com/image/Recent_Trends_Report_1209.pdf (NERA).

¹⁴ NERA, p. 15.

¹⁵ See *Securities Class Action Filings 2009: A Year in Review*, at 21, Cornerstone Research, available at www.cornerstone.com (Cornerstone).

¹⁶ According to the database maintained by the Stanford Securities Class Action Clearinghouse, the total securities class actions filed against companies in SIC 283 or 384 was 17. The total including other SIC codes pertaining to companies involved in life sciences business, broadly defined, was 21.

¹⁷ See Kevin LaCroix, *A Closer Look at the 2009 Securities Lawsuits*, available at <http://dandodiary.com/2010/01/articles/securities-litigation/a-closer-look-at-the-2009-securities-lawsuits/> (D&O Diary).

¹⁸ Broadly classified, the allegations in the securities class actions across all industries have ranged from company-specific earnings guidance (12.3%), product/operational defects (25%), customer/vendor issues (4.5%), merger integration issues (1.6%), insider trading (11.7%), breach of fiduciary duty (7.4%), Ponzi scheme (3.6%), and accounting-related issues (19.6%). See NERA, p. 7.

corrective actions regarding same, and failing to remedy repeat violations of FDA regulations.

- Neglecting to disclose that the company had failed to “focus enough effort on filling the pipeline for new case starts” for its product.
- Misrepresenting and omitting material information concerning quality and realistic likelihood of fulfillment contracts in “backlog” when the company knew or should have known that figures for potential sales would not be met.
- Failing to report results of safety studies and falsely represented that it had completed the first phase of trials in Europe and obtained “informed consent” waiver in the EU and “compassionate waiver” in the U.S.

Most of these allegations will not withstand testing by a motion to dismiss because the plaintiffs will be unable to overcome the rigorous pleading standards set by the Private Securities Litigation Reform Act of 1995 or cases interpreting that statute. But, as discussed above, even meritless securities class actions can be disruptive and expensive.

Being Prepared for Securities Class Actions

There are things a life sciences company can do to minimize potential damage and disruption if and when it is named as a defendant in a securities class action.

Implement Disclosure Policies and Follow Them

Disclosure issues are a frequent subject of securities class actions. As demonstrated by the allegations in the 2009 cases described above, life sciences companies face a number of disclosure issues particular to their industry: progress in clinical trials; clinical trial design; the inherent benefits and limitations of patents; freedom to operate issues; variability and expert opinions; warning and regulatory actions by the FDA; scientific literature produced by third parties; prospects for FDA approval; and serious adverse effects. A company can minimize the risk of making disclosure errors by having a good system and good internal procedures surrounding the process for making public disclosures – not just in public filings, but in press releases, analyst calls, and conference materials. If your company is going to make more disclosures than are required by the SEC, as many life sciences companies

do on issues like the drug development process or the preliminary results of drug trials, it needs to understand that it will expose itself to heightened SEC, FDA, and private litigant scrutiny.

Implement Insider Trading Policies and Monitor Them

Insider trading has been a hot topic recently. Illegal insider trading generally involves buying or selling a security in a breach of relationship of trust and confidence, while in possession of material, nonpublic information about the security. Companies themselves may face liability if their employees engage in insider trading and the company’s insider trading policies and procedures are found to be inadequate. Thus, every company should have insider trading policies and procedures approved by counsel. But while having a policy in place is a good start, companies also need to ensure a rigorous implementation of their insider trading programs. This can be especially important for life sciences companies with historically volatile stock prices.

Check Your Indemnification Provisions and Directors and Officers Policies

Securities class actions pose a serious potential danger of monetary liability to directors and officers. Virtually all major public companies have directors and officers (D&O) liability insurance, and these policies can provide coverage for securities class actions. D&O insurance can also protect against derivative actions (which are brought by shareholders in the name of the corporation), SEC and other government investigations, and other claims that might arise from the directors’ and officers’ management of the company. The same is true of corporate indemnification provisions, under which a corporation can agree to indemnify its directors and officers against most liability, with some exceptions, such as (1) illegal acts, (2) actions undertaken in “bad faith,” and (3) self-dealing. Together, D&O insurance and corporate indemnification protect corporate management’s personal assets and contribute to good corporate governance by ensuring that management is free to manage the corporation with a minimized risk of personal liability. Corporate officers and directors need to ensure their D&O policies are robust and the company’s indemnification provisions are up to date.

Maintain the Right Tone at the Top

A company will benefit by being able to demonstrate in cases brought both by private litigants as well as by the SEC or other regulators, that its directors, officers, and other high-level employees believe in and promote the company's policies. This is known as maintaining the right "tone at the top" and is often a key issue in securities class actions. The company should be sure that its top executives (1) have read the company's policies and follow them, (2) are familiar with the company's controls and promote them, (3) investigate (independently where necessary) allegations of wrongdoing received from credible sources, and, if necessary, (4) take action if a violation of policies or controls is found to have occurred. A company should consider creating a hotline for employees to report suspected wrongdoing. It is equally important for the company to promote a long term view of revenue and growth, even when such view might be difficult. Maintaining the right tone at the top makes it more difficult for plaintiffs or the government to demonstrate a culture of fraud and a willingness to mislead investors for the sake of increased profits, factors often needed to prove scienter — or an intent to mislead investors by the company — and makes it more likely that any representation that was later discovered to be false was merely a mistake.

No amount of planning can provide certainty that a public company will avoid becoming a defendant in a securities class action. This is inherent in the uncertain nature of securities fraud — distinguishing fraud from innocent business reversals or setbacks is often very difficult from the outside. But life sciences companies, like all companies, should take certain steps — especially maintaining the right tone at the top — that can minimize their risk of exposure to this expensive and disruptive type of litigation. ■

SEC v. Cohmad: Defendants Prevail in Battle of Inferences

By Jennifer Poppe and Nikolay Vydashenko

In one of the first significant decisions rendered in litigation arising out of the Madoff Ponzi scheme, Judge Louis Stanton of the U.S. District Court for the Southern District of New York dismissed securities fraud claims brought by the Securities and Exchange Commission (SEC) against Cohmad Securities Corporation (Cohmad), its Chairman and CEO Maurice Cohn, its President and COO Marcia Cohn, (Cohmad and the Cohns collectively, the "Cohmad Defendants"), and its former Vice President Robert Jaffe (collectively, "Defendants").¹⁹ The court allowed certain claims alleging technical violations of the securities laws to proceed, and granted the SEC leave to file an amended complaint.

This decision illustrates how defendants may succeed at the motion to dismiss stage by, in addition to pointing to the lack of plausibility of plaintiffs' allegations, affirmatively offering competing inferences that may be drawn from plaintiffs' allegations. In response to the SEC's allegations aimed at establishing a "strong inference" of scienter, *i.e.*, fraudulent intent, the Defendants offered both specific competing inferences that addressed certain of the allegations, and an overarching competing explanation that addressed the SEC's principal theory, which was that the Defendants should have known of Madoff's Ponzi scheme due to their relationship with Madoff. The Cohmad Defendants' primary competing explanation was that "the defendants were not the only ones who Madoff fooled" and that "Madoff's principal regulators . . . as well as sophisticated financial institutions, individuals, and other market participants, also were unable to discover the fraud Madoff perpetrated for more than twenty years."²⁰ The court appeared to credit the Cohmad Defendants' explanation, as it concluded that "the complaint supports the reasonable inference that Madoff fooled

¹⁹ *S.E.C. v. Cohmad Sec. Corp.*, No. 09 Civ. 5680, 2010 WL 363844 (S.D.N.Y. Feb. 2, 2010). Vinson & Elkins LLP represents Cohmad Securities Corporation, Maurice Cohn, and Marcia Cohn in this action.

²⁰ The Cohmad Defendants' Motion to Dismiss, p. 1.

the defendants as he did individual investors, financial institutions, and regulators.”²¹

Judge Stanton’s decision also has significance for future cases brought by regulators, because it reaffirms that the Supreme Court’s landmark *Iqbal* decision, requiring a complaint to “contain sufficient factual matter . . . to state a claim for relief that is plausible on its face,”²² applies with equal force to claims brought by both private litigants and regulators.

The SEC’s Enforcement Action

Following Madoff’s admission that he was operating a Ponzi scheme, the SEC commenced enforcement actions against a number of other entities and individuals who referred investors to Bernard L. Madoff Investment Securities, LLC (BMIS) — Madoff’s investment advisory business that was generating fictitious profits. The SEC’s action against the Defendants is one of the first Madoff-related cases to produce a decision at the motion to dismiss stage.

In its complaint, the SEC alleged that Madoff used Cohmad, a registered broker-dealer, to market BMIS. BMIS allegedly paid Cohmad and Cohmad’s registered representatives fees for referring investors to BMIS, and Cohmad allegedly derived a majority of its revenues from these referral fees.²³ The SEC did not allege that the Defendants knew of Madoff’s fraud. Rather, the SEC’s theory of fraudulent intent was that the Defendants “helped mislead investors into believing that Madoff was too successful to need new investment and that he would only begrudgingly allow a privileged few (and well-connected) investors to give him money to manage.”²⁴

The SEC’s complaint alleged two types of claims, categorized by Judge Stanton as “securities fraud claims” and “technical” violations claims.²⁵ The securities fraud claims assert that the Defendants violated and aided and abetted Madoff’s violations of § 10(b) of the Securities Exchange Act of 1934, § 17(a) of the Securities Act of 1933, and §§ 206(1) and (2) of the Investment Advisers

Act of 1940.²⁶ These claims are generally predicated upon the theory that the Defendants acted with fraudulent intent in marketing BMIS. The alleged technical violations include aiding and abetting violations of registration, compensation, and filing regulations under various provisions of the Exchange Act of 1934 and the Investment Advisers Act of 1940. Unlike the securities fraud claims, these latter claims do not require the SEC to plead and prove the Defendants’ fraudulent intent.

The Motions to Dismiss

The Defendants moved to dismiss all of the securities fraud claims and certain of the technical violations claims asserted against them.

The Cohmad Defendants principally argued that the SEC’s complaint contained so few factual allegations — as opposed to speculative statements and legal conclusions — that it failed to satisfy the requirements of *Iqbal* and *Twombly*²⁷ that a claim be plausible on its face. Specifically, Defendants pointed to the SEC’s failure to identify (1) any act, statement, or omission by any of the Defendants that defrauded any investors, and (2) any “red flags” that plausibly may have established Defendants’ recklessness in failing to detect Madoff’s fraud.

The Cohmad Defendants also argued that the SEC’s complaint failed to establish a “strong inference” of Defendant’s fraudulent intent. To state the securities fraud claims alleged in the complaint, the SEC was required to plead facts giving rise to a strong inference of the Defendants’ fraudulent intent. In accordance with the plausibility requirements of *Iqbal* and *Twombly*, this required allegations of facts (not legal conclusions) that (1) show the Defendants had “both motive and opportunity to commit fraud,” or (2) “constitute strong circumstantial evidence of conscious misbehavior or recklessness.”²⁸ According to the Cohmad Defendants, rather than establishing a “strong inference” of fraudulent intent, the SEC’s allegations led to the inference that Madoff fooled the Defendants, along with many other market participants and regulators.

²¹ *Cohmad*, 2010 WL 363844 at *2.

²² *Ashcroft v. Iqbal*, ___ U.S. ___, 129 S. Ct. 1937, 1949 (2009).

²³ *Cohmad*, 2010 WL 363844 at *1.

²⁴ SEC’s Memorandum of Law in Opposition to Cohmad and the Cohn’s Motion to Dismiss, p. 1.

²⁵ *Cohmad*, 2010 WL 363844 at *1.

²⁶ *Id.*

²⁷ *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007).

²⁸ *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001).

The Court's Decision

The court's decision rested on the initial premise that, [t]here is nothing inherently fraudulent about referring customers to an investment adviser for fees, and the complaint does not allege statements or omissions by defendants that are fraudulent absent awareness or notice that Madoff's investment advisory business was a sham. Thus, to state its securities fraud claims, the SEC must show that defendants knew of, or recklessly disregarded, Madoff's fraud. In other words, one who conducts normal business activities while ignorant that those activities are furthering a fraud is not liable for securities fraud.²⁹

Securities fraud claims

Judge Stanton's analysis of the securities fraud claims focused on the element of fraudulent intent, as this element is required to state all of the SEC's alleged securities fraud claims. The court grouped the SEC's fraudulent intent allegations in four categories, and found that each category of allegations failed to show knowledge, or reckless disregard, of Madoff's fraud.³⁰

Cohmad's compensation arrangement

The SEC's first attempt to plead the requisite scienter centered on allegations concerning Cohmad's compensation arrangement with BMIS. The SEC alleged that BMIS compensated Cohmad each year with a percentage of the original capital investment brought into BMIS by Cohmad registered representatives for as long as the investor's account was open, provided that the amount of capital subject to fee calculations was reduced by any withdrawals made from the investor's account. According to the SEC, this arrangement served to motivate the Cohmad Defendants to "discourage investors from withdrawing any funds that might exceed the amount of the individual investments."³¹

The Cohmad Defendants argued that the compensation arrangement was consistent with Cohmad's alleged role, which was to introduce prospective investors

to BMIS. Given this limited role, it made sense "that Madoff would have compensated Cohmad based on the amount of funds new investors brought to BMIS through Cohmad rather than on any subsequent appreciation in the accounts attributable to BMIS's trading prowess."³² The court agreed with the inference offered by the Cohmad Defendants, reasoning that "Cohmad referred customers to a purported investment adviser and provided customer service, but it had no role in investment decisions, so it is logical that Cohmad did not earn fees on 'profits' from investment."³³

Madoff's requests for secrecy

The second category of scienter allegations was Madoff's requests for secrecy concerning the investment advisory business. The SEC alleged that Madoff requested secrecy in marketing BMIS by banning written marketing materials and making it known that investments from anyone who worked in the securities industry would not be accepted as such investors would "ask too many questions."³⁴ Accordingly, Cohmad representatives allegedly "strategically circulated among wealthy individuals in exclusive milieus" and "projected themselves as individuals who became wealthy through BMIS," and, when approached by potential investors who asked if they could invest with BMIS, would "agree to try to put in a good word with Madoff."³⁵

The court held that these allegations amount to "fraud by hindsight," which cannot be used to allege an intent to defraud.³⁶ Rather than accepting the SEC's inferences, which were improperly colored by hindsight, the court credited the Cohmad Defendants' competing explanation for Madoff's secrecy, quoting from their motion to dismiss that "anyone who watches TV commercials or reads magazine ads can attest that the projection of an 'aura of exclusivity' is a common marketing tactic."³⁷ Thus, the court held that Madoff's alleged desire for secrecy did not lead to a plausible inference that the

²⁹ *Cohmad*, 2010 WL 363844 at *1.

³⁰ *Id.* at *3.

³¹ *Id.*

³² The Cohmad Defendants' Motion to Dismiss, p. 25.

³³ *Cohmad*, 2010 WL 363844 at *3.

³⁴ *Id.*, quoting SEC's complaint, ¶ 48.

³⁵ *Id.* at *4, quoting SEC's complaint, ¶ 26.

³⁶ *Id.* at *4.

³⁷ *Id.*, quoting the Cohmad Defendants' Memorandum of Law in Support of Motion to Dismiss, p. 25.

Cohmad Defendants should have known that he was engaged in a massive Ponzi scheme.³⁸

Cohmad's alleged technical violations

The third category of scienter allegations was Cohmad's alleged failure to disclose the full extent of its relationship with BMIS in Cohmad's regulatory filings and books and records. According to the SEC, Cohmad's business relationship with BMIS was inadequately described in Cohmad's Form BD and its Annual Audit Reports.³⁹

The court held that in the absence of any other facts showing that Defendants were on notice of Madoff's fraud, the SEC's chain of inferences — that Cohmad's alleged failure to disclose the full extent of its relationship with BMIS showed an intention to conceal that relationship, and that such concealment was undertaken because Defendants knew that Madoff was committing fraud — is “speculative and flimsy.”⁴⁰

Alleged irregularities in Jaffe's BMIS accounts

The fourth category of scienter allegations relates to Jaffe only. The SEC alleged that there were irregularities in Jaffe's BMIS accounts, such as outsized annual returns and a backdated trade.⁴¹ The court held that the high returns could not be viewed as suspicious in light of Madoff's reputation, and that Jaffe may have reasonably believed that the single backdated trade over the twelve years that he maintained his account with BMIS was a result of an innocent error.⁴²

Technical Violations Claims

In Counts 5 and 7 of its complaint, the SEC alleges that the Cohmad Defendants aided and abetted BMIS's violations of § 206(4) of the Investment Advisers Act and Rule 206(4)-3 thereunder, and of § 15(b)(7) of the Exchange Act and Rule 15b7-1 thereunder.

The court held that the SEC failed to plead the requisite elements of these claims, because the complaint does not allege that the Cohmad Defendants performed any acts that would have enabled BMIS's violations, such as holding

themselves out as BMIS registered representatives or hiding their relationship with BMIS from clients that the Cohmad Defendants allegedly solicited.⁴³

In Count 6 of its complaint, the SEC alleged that Maurice Cohn and Marcia Cohn aided and abetted Cohmad's violation of § 15(b)(1) of the Exchange Act and Rule 15(b)-3 thereunder, which requires a broker-dealer's Form BD and amendments to be accurate. Only Maurice Cohn moved to dismiss this Count, arguing that he was not liable because he did not sign the Forms BD and amendments at issue. The court denied this aspect of the motion to dismiss, holding that Maurice Cohn's position as Chairman and CEO of Cohmad conferred upon him a duty to ensure that the filings were accurate.⁴⁴

* * *

The *Cohmad* decision illustrates the ability of defendants in securities fraud cases to successfully challenge the reasonableness and plausibility of the inferences to be drawn from the plaintiffs' allegations, even in cases where the plaintiff is a regulator. Moreover, the decision illustrates the persuasive power of offering the defendant's own, competing inferences at the motion to dismiss stage. The imperative to offer a competing, innocent explanation is even more essential where the theory of liability is premised on defendant's alleged role in assisting a much larger fraud. ■

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³⁸ *Id.*

³⁹ *Id.* at *4-5.

⁴⁰ *Id.* at *5.

⁴¹ *Id.*

⁴² *Id.* at *5-6.

⁴³ *Id.* at *6.

⁴⁴ *Id.* at *7.

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