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Hurdles in Private Securities Fraud Litigation:
An Overview

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Over the past 20 years, new federal legislation and judicial interpretations of new and existing laws have increased the obstacles facing plaintiffs in securities fraud class actions. The timing and detail required at both the pleading and class certification stages have affected plaintiffs' upfront costs as well as arguably reducing the number of cases which go to completion, whether via trial or court-approved settlement.[1] In addition, plaintiffs' ability to seek recovery from "secondary actors" and foreign issuers continues to be restricted by the courts.

Background

The federal securities laws were put into place following, and as a response to, the stock market crash of 1929. The Securities Act of 1933[2] (Securities Act) governs offers and sales of securities, and the Securities Exchange Act of 1934[3] (Exchange Act) governs trading in securities after they are issued. Both laws require periodic public disclosures by the issuer in order to increase the knowledge and efficiency of the markets and various remedies for investors who are injured as a result of their violation.

Section 10(b) of the Exchange Act and Rule 10b-5,[4] promulgated by the Securities and Exchange Commission (SEC) pursuant to the authority of the Exchange Act, prohibit material misstatements or omissions and fraud in connection with the purchase or sale of a security. Neither § 10(b) nor Rule 10b-5 *expressly* creates a private right of action for persons seeking redress for violations of those provisions. However, as

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early as the 1940s, these rules have been interpreted by the federal courts as creating an *implied* private right of action, recognizing "that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions... ."[5]

The basis for the private securities fraud cause of action has been fashioned over the years by the courts. The U.S. Supreme Court has stated that there are six elements which a plaintiff must allege and prove to succeed in a § 10b-5 lawsuit:

1. material misstatement or omission by the defendant;
2. scienter, *i.e.*, intention to deceive, manipulate, or defraud;
3. purchase or sale of a security;
4. reliance upon the material misstatement or omission;
5. economic loss; and
6. loss causation.[6]

In order to prevail at trial, a plaintiff must prove each of these elements.

Private Securities Litigation Reform Act

Private securities fraud lawsuits are usually framed as class actions, which enable a large number of investors with similar claims, but without the means to pay for the costs of litigation, to pursue their claims together and to be able to engage experienced plaintiffs' counsel to represent the class. During the second half of the 20th century, many noted the potential for abuse in securities fraud class actions. Control of the process was largely ceded to plaintiffs' counsel who used "professional" lead plaintiffs and raced to get a complaint on file first to get a better shot at having their client named lead plaintiff and being named class counsel.

Neither Section 10(b) nor Rule 10b-5 expressly creates a private right of action for persons seeking redress for violations of those provisions. However, as early as the 1940s, these rules have been interpreted by the federal courts as creating an implied private right of action…

The Private Securities Litigation Reform Act of 1995[7] (Reform Act) was enacted by Congress, over a presidential veto, to counter the perceived abuses in class action lawsuits. Many believed that meritless lawsuits were routinely filed after any significant change in the trading price of an issuer's stock, whether or not there was any fraudulent behavior involved. Such routine filings were believed to be made for their settlement value since defendants would find it less expensive to settle a securities fraud class action rather than go through expensive discovery phase and face a potentially massive damages award at trial. Congress enacted the Reform Act "to curb perceived abuses of the §10(b) private action."[8] The Reform Act attempts to eliminate frivolous securities fraud class actions and to reduce the cost to defendants caused by these nonmeritorious lawsuits in a number of ways, including imposing procedural hurdles in the early stages of the litigation.

Motion to Dismiss; Discovery Stay; Pleading Requirements

At the outset, the Reform Act subjects all securities fraud class actions to potential dismissal based upon the pleadings. If the pleadings fail to adequately establish that the defendant made a material misstatement or omission and acted knowingly or recklessly, then the statute directs the court, on the motion of any defendant, to dismiss the complaint. In addition, no discovery will normally be permitted unless the plaintiff defeats the motion to dismiss. This court-imposed stay is intended to avoid, in a meritless action, the sub-

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stantial cost to defendants associated with the discovery process (which in some instances was estimated to be as much as 80% of the cost of the litigation to defendants).[9] Therefore, plaintiffs must meet the strict pleading requirements imposed by the statute and judicial interpretation without the benefit of information which might be gleaned from discovery.

Pursuant to Federal Rule of Civil Procedure Rule 9, all claims of fraud must be plead with "particularity." In its 2007 decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court indicated that the Reform Act requires an even stricter standard for pleadings in private securities fraud actions.[10] The complaint must set forth each statement alleged to have been misleading, as well as the reasons why each statement is misleading. In addition, the pleadings must state with particularity the facts giving rise to a "strong" inference that the defendant acted with scienter (intentionally or recklessly).[11] Four years later, in *Matrixx Initiatives, Inc. v. Siracusano,*[12] the Supreme Court upheld the U.S. Appeals Court for the Ninth Circuit's reversal of a district court's dismissal of a securities fraud class action. The Supreme Court refused to impose a bright line test when determining whether the plaintiffs had adequately pleaded the elements of a material misstatement or omission. Defendant Matrixx Initiatives, maker of the Zicam nasal drug, had argued that there was no material misstatement or omission since there was no data indicating that there was a statistically significant risk linking its drug and certain adverse events. The Court instead indicated that the "total mix" standard from *Basic Inc. v. Levinson,*[13] is the materiality test to be applied.

The statute does not define what constitutes a "strong" inference of scienter, but the Supreme Court addressed this issue in *Tellabs*. The Court held that to qualify as "strong," an inference of scienter "must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[14] In that opinion, the Court established the following prescriptions: accept all factual allegations in the complaint as true; consider the complaint in its entirety, including documents incorporated by reference and matters of which the court may take judicial notice; and take into account plausible opposing inferences in determining whether the pleadings give rise to a "strong" inference of scienter. The Court noted that the "strength of an inference cannot be decided in a vacuum. The inquiry is comparative… ."[15]

Class Certification

Rule 23 of the Federal Rules of Civil Procedure (FRCP) governs certification of class actions in the federal courts. In order for a class to be certified under Rule 23, and as noted by the Supreme Court in *Erica P. John Fund, Inc. v. Halliburton, Inc.*,[16] "the court must find 'that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.'" In reaching this determination in a securities fraud class action, the court will consider the six elements of a private securities fraud claim outlined above. "[W]hether common questions of law or fact predominate in a securities fraud action often turns on the element of reliance," and rather than requiring a showing that each member of a class has relied on the deceptive acts in question, the Supreme Court in *Basic* permitted plaintiffs in a class action "to invoke a rebuttable presumption of reliance by the class based upon what is known as the "fraud-on-the-market" theory." According to that theory, "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."

This court-imposed stay is intended to avoid, in a meritless action, the substantial cost to defendants associated with the discovery process (which in some instances was estimated to be as much as 80% of the cost of the litigation to defendants).

As pointed out by the Court in *Halliburton*, in order to invoke this presumption, plaintiffs must show that the alleged misrepresentation was publicly known, that the security traded in an efficient market, and that the purchase or sale occurred during the period after the misrepresentation occurred and before the truth was disclosed.[17] The Supreme Court specifically rejected the Fifth Circuit's requirement that plaintiffs also demonstrate loss causation in order to obtain class certification.

Appointment of Lead Plaintiff

In a private securities fraud class action, the appointment of the lead plaintiff is governed by the provisions of the Reform Act.[18] Before the Reform Act was enacted, it was common practice for a court to appoint as lead plaintiff, the plaintiff in the first action filed for an alleged violation, which often created a race to the courthouse by class action plaintiff attorneys. Unlike the prior procedure, the Reform Act creates a presumption that the most adequate plaintiff in any securities fraud private action is the person or group that, in the determination of the court, has the largest financial interest in the relief sought by the class. In addition, any proposed lead plaintiff must certify, among other things, that the plaintiff will not accept any payment for serving as lead plaintiff. These provisions were designed to involve institutional shareholders in the class action process as lead plaintiffs on the theory that such a shareholder would have greater ability and incentive to exert control over class counsel.

It is interesting to note that some observers have expressed a concern that the institutional shareholder may not adequately share the interests of smaller individual shareholders and have suggested the idea of colead plaintiff consisting of an institutional shareholder and an individual shareholder.[19]

Safe Harbor for Forward Looking Statements

To encourage the flow of information from issuers into the market, the Reform Act amended the Exchange Act to provide a safe harbor for issuers and certain others for statements about certain anticipated future performance or events. The law provides that a covered person is not liable in private securities fraud actions for forward looking statements that are identified as such and are accompanied by meaningful cautionary language or that are immaterial or that the plaintiff fails to prove were made with actual knowledge that such statements were false or misleading.[20]

Other Matters Covered by the Reform Act

In addition to the foregoing, the Reform Act imposes:

- a cap on damages;
- proportionate liability (rather than joint and several liability) in certain circumstances;
- a prohibition on RICO claims in private securities fraud cases;
- a reasonable limit on attorney's fees; and
- a requirement that the court review each case to determine whether sanctions should be imposed for frivolous claims.

Securities Litigation Uniform Standards Act & Class Action Fairness Act

Following enactment of the Reform Act in 1995, many plaintiffs pursued their claims in state courts in an effort to circumvent the Reform Act's restrictions. Congress responded by adopting the Securities Litigation Uniform Standards Act of 1998[21] (SLUSA) to prevent state private securities class action lawsuits from being used to frustrate the objectives of the Reform Act.

SLUSA amended both the Securities Act and the Exchange Act by inserting identical language, which provides that: "No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—(1) an untrue statement or omission of a material fact in connection with the purchase or

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sale of a covered security; or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security."

A covered class action is generally defined as any lawsuit in which a plaintiff seeks damages on behalf of himself and more than 50 persons with similar claims, or any group of lawsuits which are consolidated or otherwise proceed as a single action seeking damages for more than 50 persons. SLUSA does provide a carve-out for actions under the laws of the state where the issuer is incorporated which involve (i) purchases or sales of the issuer's securities solely from or to the issuer's shareholders; or (ii) communications with respect to the sale of the issuer's securities made by the issuer to its shareholders concerning shareholder decisions regarding voting their shares, responding to a tender or exchange offer or exercising dissenters' or appraisal rights.

Differences in the interpretation of the breadth of SLUSA's preemption developed among the Circuit Courts. The Second Circuit Court held that the preemption only applied to state class actions to the extent they are brought by persons in their capacity as a purchaser or seller of a security, while the Seventh Circuit adopted a broader interpretation of the preemption that encompassed plaintiffs suing in their capacity as shareholders as well. In 2006, the Supreme Court resolved these differences in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit.*[22] In *Dabit,* the Supreme Court interpreted SLUSA to preempt all state class actions based on alleged misrepresentations, omissions or manipulative or deceptive acts, whether or not the claim arose from a purchase or sale of securities. The Court noted that this interpretation of SLUSA gives effect to its explicit purpose of preventing end runs around the Reform Act by filing class actions in state court.

The Class Action Fairness Act of 2005[23] (CAFA) is not directed exclusively at state securities class actions. However, its provisions may affect certain of those actions which do not come within the ambit of SLUSA, *e.g.,* securities fraud class actions on behalf of fewer than 50 persons, as unlikely as that may be. CAFA permits removal to federal court of certain class actions involving more than $5 million when any class member resides in a different state from any of the defendants; provided, that such actions may remain in state court if at least two-thirds of the class and the primary defendants are in the state of the initial filing.

Additional Hurdles in Private Securities Fraud Litigation

Secondary Actors

Commencing with its 1994 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,*[24] the Supreme Court has greatly restricted the ability of private plaintiffs to recover from nonissuers under the federal securities laws. In *Central Bank,* the Court held that § 10(b) and Rule 10b-5 do not create an implied private right of action for aiding and abetting. This holding was reaffirmed in 2008 in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[25] The Court emphasized the importance of the element of reliance and found that persons who were part of a scheme to defraud (in *Stoneridge*, customers and suppliers) were not primarily liable under Rule 10b-5 because investors did not rely on the secondary actors' fraudulent conduct.

The Court noted that this interpretation of SLUSA [in Dabit] gives effect to its explicit purpose of preventing end runs around the Reform Act by filing class actions in state court.

More recently, the Court stated in *Janus Capital Group, Inc. v. First Derivative Traders*[26] that an investment advisor could not be held liable for false and misleading statements in its client's prospectus even though the advisor had common officers with the client and had participated in the preparation and dissemination of the prospectus. The Court found that the fraudulent statements in the prospectus were made by the client and that the advisor was not liable.

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The Court did note, however, that secondary actors could still be found liable if they were to engage directly, rather than solely through the client's prospectus, in material misrepresentations.

Extraterritoriality

Last year, the Supreme Court further restricted the ability of private plaintiffs to seek redress for violations of the federal securities laws by foreign issuers. In *Morrison v. National Australia Bank*,[27] the Court held that § 10(b) and Rule 10b-5 do not extend to transactions in securities of foreign issuers on foreign exchanges. The Court held that a "conduct and effects" test, which applied § 10(b) to foreign-traded securities when either the wrongful conduct occurred in the U.S. or the effects of the conduct were felt here, ignored the "presumption against extraterritoriality." Absent a clear intent of Congress, a statute should not be construed to apply to overseas conduct.

Subsequent to the decision, a number of lower courts have applied *Morrison*'s rationale to reject a variety of arguments that U.S. securities laws should be applied to foreign trades.[28]

Conclusion

Over the past two decades, private securities fraud class action practice has been reshaped as a result of a combination of new federal legislation and decisions in the federal courts, including landmark decisions by the Supreme Court, from *Central Bank* to *Janus* to *Morrison*.

The securities litigation practice is now essentially limited to the federal courts and to causes of action against those with primary liability arising from purchases and sales in securities listed on domestic exchanges and domestic transactions in other securities. Pleadings must be specific and clear in alleging fraud and scienter and must be able to withstand—without the benefit of discovery—a district court's rigorous review when considering a motion to dismiss the action. Private plaintiffs do not have a right of action against secondary actors, such as accountants, underwriters, customers, and suppliers, for aiding and abetting an issuer's fraud. Such actors may be pursued for primary liability, but only if the actor ultimately has authority over the false statement from which the plaintiff's claim arises.

NOTES

1. *See*, however, Choi, Nelson & Pritchard, *The Screening Effect of the Private Securities Litigation Reform Act*, J. Empirical Legal Stud., 6, no. 1 (2009).
2. The Securities Act of 1933; 15 U.S.C.A. §§ 77a et seq.
3. The Exchange Act of 1934; 15 U.S.C.A. §§ 78a et seq.
4. SEC Rule 10b-5; 17 C.F.R. § 240.10b-5.
5. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S. Ct. 2499, 168 L. Ed. 2d 179, Fed. Sec. L. Rep. (CCH) P 94335 (2007).
6. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-342, 125 S. Ct. 1627, 161 L. Ed. 2d 577, Blue Sky L. Rep. (CCH) P 74529, Fed. Sec. L. Rep. (CCH) P 93218 (2005).
7. Pub.L.No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of titles 15 & 18 of the U.S. Code).
8. *Tellabs*, 551 U.S. at 320.
9. Coppolo, *Private Securities Litigation Reform Act*, OLR Research Report, 2002-R-0695 (2002) at 6.
10. *Tellabs*, 551 U.S. at 319.
11. Private Securities Litigation Reform Act (Reform Act); 15 U.S.C.A. § 78u-4(b)(1) & (2).
12. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 179 L. Ed. 2d 398, Fed. Sec. L. Rep. (CCH) P 96249 (2011).
13. *Basic Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988).
14. *Tellabs*, 551 U.S. at 324.
15. *Tellabs*, 551 U.S. at 323.
16. *Erica P. John Fund, Inc. v. Halliburton, Inc.*, 131 S. Ct. 2179, 2181, 180 L. Ed. 2d 24, Fed. Sec. L. Rep. (CCH) P 96323, 79 Fed. R. Serv. 3d 945 (2011).
17. *Halliburton*, 131 S. Ct. at 2181-2182. .
18. 15 U.S.C.A. § 78u-4(a).
19. *See, e.g.*, Choi, Fisch & Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 Wash.U.LawQuart. 869 (2005).
20. The Reform Act; 15 U.S.C.A. § 78u-5.
21. The Securities Litigation Uniform Standards Act of 1998; 15 U.S.C.A. § 78bb.
22. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 126 S. Ct. 1503, 164 L. Ed. 2d 179, Blue Sky L. Rep. (CCH) P 74569, Fed. Sec. L. Rep. (CCH) P 93723 (2006).

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23. The Class Action Fairness Act of 2005; Pub.L. 109-2-Feb. 18, 2005 (amending scattered sections of Title 28 of U.S. Code).
24. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119, Fed. Sec. L. Rep. (CCH) P 98178 (1994).
25. *Stoneridge Investment Partner, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S. Ct. 761, 169 L. Ed. 2d 627, Fed. Sec. L. Rep. (CCH) P 94556 (2008).
26. *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 180 L. Ed. 2d 166, Fed. Sec. L. Rep. (CCH) P 96327 (2011).
27. *Morrison v. National Australia Bank*, 130 S. Ct. 2869, 177 L. Ed. 2d 535, Fed. Sec. L. Rep. (CCH) P 95776, R.I.C.O. Bus. Disp. Guide (CCH) P 11932, 76 Fed. R. Serv. 3d 1330 (2010).
28. Gallardo, *Securities Litigation Update*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (February 12, 2011).

In *Fait v. Regions Financial*, Second Circuit Establishes More Stringent Pleading Standard for Securities Act Claims Based on Statements of Opinion

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On August 23, the Court of Appeals for the Second Circuit decided *Fait* v. *Regions Financial Corp.*,[1] in which the Court affirmed the dismissal of a putative class action alleging violations of §§ 11(a), 12(a)(2), and 15 of the Securities Act of 1933 (Securities Act). The Second Circuit held that defendants' alleged failures to write down goodwill in a timely manner and to increase loan loss reserves sufficiently during the financial crisis were not actionable, because defendants' challenged statements were matters of opinion rather than fact.

Thus, plaintiffs had to allege that defendants did not believe the statements were true at the time they were made, something the complaint failed to do. *Fait* promises to be a useful tool in defending claims under the Securities Act, as well as claims that a defendant otherwise misstated financial figures, when those figures depend on the judgment of management rather than strictly objective criteria. The decision may be particularly important with respect to claims against accounting firms, whose conclusions based on their audits of financial statements and internal control regularly take the form of an expression of opinion.

The allegations in *Fait* centered on 10-K for the year 2007 (later incorporated into a registration statement and prospectus) of defendant Regions Financial Corp., a bank holding company. Regions reported that it held $11.5 billion in goodwill, a measure of the excess purchase price paid by Regions in prior acquisitions over the net fair value of the assets acquired.[2] Regions also reported $555 million in loan loss reserves, a balance set aside to cover expected losses in its loan portfolio.[3] Regions disclosed dramatic changes in these figures a year later: in its results for the fourth quarter of 2008, Regions reported a $6-billion goodwill impairment and an increase in loan loss provisions to $1.15 billion.[4] In the following months, Regions' stock price fell and plaintiffs filed suit, alleging that despite adverse trends in the mortgage and housing markets, Regions

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