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56

CURRENT TOPICS ON SECURITIES LITIGATION

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Table of Contents

I. ISSUES AT CLASS CERTIFICATION

Reliance is a *prima facie* element of any claim for violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder. Traditionally, reliance requires a showing that the plaintiff heard or read the alleged misrepresentations, and purchased the security at issue because of them. However, the vast majority of investors do not scrutinize the SEC filings issued by the companies in which they hold stock, and would lack a remedy if the requirement of actual, direct reliance was adhered to. Therefore, the Supreme Court has recognized a species of indirect reliance in the context of securities traded on public exchanges known as the fraud-on-the-market doctrine.[1]

The fraud-on-the-market doctrine is a judicial presumption that investors in publicly-traded securities buy those securities in reliance on the integrity of the market prices of those securities, and that the market makers who set the market prices of those securities rely on all material public information in valuing those securities. Therefore, a plaintiff can invoke a presumption of reliance by proving that he relied on the integrity of the market price of the security, and that that price was inflated by the alleged misrepresentations at issue.

This presumption is critical to the susceptibility of securities litigation to class treatment. Generally, class certification in claims for monetary damages is appropriate only where the court finds that "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." FED.R.CIV.P. 23(b)(3). Without the fraud-on-the-market presumption, no such predominance exists, because individual questions of reliance exist as to each class member.

Although courts have shown a willingness to apply the fraud-on-the-market presumption liberally, defendants in securities actions have attempted to establish a number of fact-specific carve outs, with varying success.

A. Loss Causation at the Class Certification Stage

One issue that has received a great deal of attention recently is whether loss causation is relevant to the propriety of class

1. *See Basic Inc. v. Levinson,* 485 U.S. 224 (1988).

certification because of how it bears on the fraud-on-the-market presumption. Defendants have argued strenuously in the affirmative, reasoning that class certification of a typical Section 10(b) action is impossible without the fraud-on-the-market presumption, and the fraud-on-the-market presumption is by definition inapplicable if the market did not rely on the misrepresentations at issue. Therefore, they have argued that securities plaintiffs should be required to prove loss causation at the class certification stage, or at a minimum, that defendants should be permitted to rebut the fraud-on-the-market presumption by disproving loss causation.

The Fifth Circuit Court of Appeals has taken the strongest stance on this question, holding that a plaintiff attempting to invoke the fraud-on-the-market presumption must prove loss causation to be entitled to class certification. The seminal decision in this regard is *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007). In *Oscar*, the plaintiff brought a class action against Allegiance Telecom based on misrepresentations concerning the number of new phone lines the company had installed. The Fifth Circuit reversed the district court's order granting class certification, holding that because "[t]he plaintiff's expert report did not establish loss causation," the "plaintiffs . . . failed to trigger the presumption of reliance provided by the fraud-on-the-market theory" and therefore "the district court abused its discretion in certifying the class." 487 F.3d at 271-72.

The Fifth Circuit has reiterated the holding in *Oscar* in a number of subsequent decisions,[2] but the other circuits have not embraced *Oscar*, at least not wholeheartedly. The Second Circuit Court of Appeals has imported the notion that loss causation can be relevant to the propriety of class certification, but has rejected the Fifth Circuit's position that the plaintiff bears the burden of proof on this issue. Rather, "the court must permit defendants to present their rebuttal arguments 'before certifying a class,'" and such rebuttal can include a submission of "evidence to show that the misrepresentations did not affect market price." *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 485 (2d Cir. 2008). The Second Circuit has also held that

2. *See Luskin v. Intervoice-Brite, Inc.*, 261 Fed. Appx. 697, 701 (5th Cir. 2008); *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.,* 597 F.3d 330 (5th Cir. 2010); *Alaska Elec. Pension Fund v. Flowserve Corp.,* 572 F.3d 221 (5th Cir. 2009); *Fener v. Operating Engr's Constr. Indus. & Misc. Pension Fund*, 579 F.3d 401 (Local 66) (2009).

the issue of loss causation can defeat class certification where the would-be lead plaintiff sold his stock before the truth was revealed to the market, and therefore would be subject to unique defenses at trial. *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 574 F.3d 29, 39 (2d Cir. 2009).[3]

No other Court of Appeals has squarely addressed *Oscar*. However, *Oscar's* holding has been flatly rejected by district courts in the First Circuit,[4] Third Circuit,[5] Fourth Circuit,[6] Sixth Circuit,[7]

3. The willingness of the Second and Fifth Circuit to delve into loss causation issues at the class certification stage is part of a broader movement by the courts toward considering matters at class certification that traditionally were reserved for summary judgment, to the extent that the requirements for certification overlap with the merits. The Seventh Circuit recently held in *American Honda Motor Co. v. Allen,* 600 F.3d 813 (7th Cir. 2010) that the district court erred in granting class certification despite expressing "definite reservations about the reliability" of the expert report submitted in support of the plaintiffs' motion. The court noted that "a district court must make whatever factual and legal inquiries are necessary to ensure that requirements for class certification are satisfied . . . even if those considerations overlap the merits of the case." The court concluded that "when an expert's report or testimony is critical to class certification . . . a district court must conclusively rule on any challenge to the expert's qualifications or submissions prior to ruling on a class certification motion." 600 F.3d at 815.
4. *In re Boston Scientific Corp. Sec. Litig.*, 604 F. Supp. 2d 275, 286 (D. Mass. 2009) ("Recent First Circuit authority indicates that evaluation of evidence of market impact at the class certification stage should differ from the approaches of the Fifth Circuit and Second Circuit."); *In re Credit Suisse-AOL Sec. Litig.*, 253 F.R.D. 17, 30 n.16 (D. Mass. 2008) ("deciding the issue of market impact/loss causation at this point in the proceedings would require the Court to stretch the strictures of Rule 23 to their breaking point").
5. *In re DVI Inc. Sec. Litig.*, 249 F.R.D. 196, 219 (E.D. Pa. 2008) ("while Lead Plaintiffs will face a difficult task establishing loss causation for those class members who sold their DVI securities before May 20, 2003, we cannot properly make this factual determination at the class certification stage").
6. *In re Red Hat, Inc. Sec. Litig.*, 261 F.R.D. 83, 94 (E.D.N.C. 2009) ("despite the fact that the court is required to undertake a 'rigorous' analysis for purposes of class certification," the issue of loss causation "simply cannot be resolved at this stage" given "that limited merits discovery has been undertaken"); *In re Mills Corp. Sec. Litig.*, 257 F.R.D. 101, 108 (E.D. Va. 2009) ("Requiring a plaintiff to 'prove' loss causation at class certification risks converting class certification into a hearing on the merits" and "could require a court to rule on factual issues prior to meaningful discovery.")
7. *Ross v. Abercrombie & Fitch Co.*, 257 F.R.D. 435, 454 (S.D. Ohio 2009) (questions regarding loss causation "address the merits of Plaintiff's claims, and cannot be adjudicated at the class certification stage").

Seventh Circuit,[8] Ninth Circuit,[9] Tenth Circuit,[10] and Eleventh Circuit.[11]

B. Rebutting the Presumption for Lead Plaintiffs Who Continued Purchasing Stock After the Truth Was Revealed

Another way that defendants have attempted to rebut the fraud-on-the-market presumption at the class certification stage is by challenging those lead plaintiffs who continued to purchase stock even after it was revealed that a fraud had been committed. Defendants have argued that any investor who continued to purchase after the "truth" was revealed would have made his pre-revelation purchases regardless of the company's misrepresentations, and therefore should not be entitled to invoke the fraud-on-the-market presumption. This argument has met with mixed success.

A number of courts have held that a putative lead plaintiff who continued to purchase stock after the truth was revealed is an inadequate class representative because that conduct is sufficient to rebut the fraud-on-the-market presumption. For instance, in *In re Cardinal Health, Inc. Securities Litigation*, 226 F.R.D. 298 (S.D. Ohio 2005), investors in Cardinal Health, Inc., a healthcare

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8. *Schleicher v. Wendt*, No. 02-cv-1332, 2009 WL 761157, at *12 (S.D. Ind. Mar. 20, 2009) ("it is not the court's job to ascertain the merit of [loss causation] at the class certification stage").
9. *In re LDK Solar Sec. Litig.*, 255 F.R.D. 519, 530 (N.D. Cal. 2009) ("although the Ninth Circuit has yet to address the [loss causation] issue specifically in the context of class certification, this circuit's precedent strongly suggests it would reject such a rule"); *In re Connetics Corp. Sec. Litig.*, 257 F.R.D. 572, 579 (N.D. Cal. 2009) ("at this stage, lead plaintiff need show only that [the stock] traded on an efficient market"); *In re Micron Techs., Inc. Sec. Litig.*, 247 F.R.D. 627, 634 (D. Idaho 2007) ("While defendants are entitled to rebut that presumption, that issue is appropriate for resolution only after discovery."); *Conn. Ret. Plans & Trust Funds v. Amgen, Inc.*, No. 07-cv-2536, 2009 WL 2633743, at *12 (C.D. Cal. Aug. 12, 2009) ("to trigger the presumption of reliance, Plaintiff need only establish that an efficient market exists").
10. *In re Nature's Sunshine Product's. Inc. Sec. Litig.*, 251 F.R.D. 656, 665 (D. Utah 2008) ("the Court declines to adopt *Oscar* and will not require a showing of loss causation at the class certification stage").
11. *In re HealthSouth Corp. Sec. Litig.*, 257 F.R.D. 260, 283 (N.D. Ala. 2009) ("the *Oscar* case has never been followed in the Eleventh Circuit and this court will not be the first to adopt it"); *In re Netbank, Inc. Sec. Litig.*, 259 F.R.D. 656, 675 n.14 (N.D. Ca. 2009) (same).

conglomerate, filed a class action lawsuit alleging that the company had engaged in a variety of improper revenue recognition practices. The court held that one of the movants for lead plaintiff was not a suitable candidate because it had made significant purchases of the company's stock immediately after investigations into the company's accounting practices were announced. Therefore, the court reasoned, the movant was "susceptible to claims that [it] did not rely on the Defendants' alleged misrepresentations when purchasing Cardinal stock." 226 F.R.D. at 310.

Similarly, in *In re Safeguard Scientifics*, 216 F.R.D. 577 (E.D. Pa. 2003), investors in Safeguard Scientifics filed a class action alleging that Safeguard provided an improper, secret loan to its CEO in violation of Section 10(b) of the Exchange Act. The defendants opposed class certification on the ground that the lead plaintiff "increased his holdings in Safeguard stock even after public disclosure of the alleged fraud." The court agreed, finding that the plaintiff's post-revelation purchases were strong evidence that he "would have made-and in fact did-purchase stock regardless of the fraudulent omission." Therefore, the court held that "Defendants have presented compelling reason to rebut the reliance presumption" and denied class certification.[12] 216 F.R.D at 582.

12. *See also In re World Access, Inc. Sec. Litig.*, 310 F. Supp. 2d 1281, 1300 (N.D. Ga. 2004) (class certification denied due to lead plaintiff's post-revelation purchases, which "directly counter the premise upon which the fraud-on-the-market theory is based"); *Ballan v. Upjohn Co.*, 159 F.R.D. 473, 481 (W.D. Mich. 1994) (denying class certification because "[t]he evidence before the court clearly shows that plaintiff purchased Upjohn stock at the same price both several months before and shortly after October 1, 1991"); *Kovaleff v. Piano*, 142 F.R.D. 406, 408 (S.D.N.Y. 1992) (denying motion for class certification because lead plaintiff increased its holdings after disclosure of the alleged fraud and was thus subject to unique defenses); *Rolex Emps. Ret. Trust v. Mentor Graphics Corp.*, 136 F.R.D. 658, 664 (D. Or. 1991) (denying class certification because lead plaintiff "continued to trade in the stock . . . after he learned of the alleged misrepresentations," which "severs the link between the alleged misrepresentations of defendants and [his] stock purchases" and "acts to rebut the presumption" of reliance); *Koenig v. Benson*, 117 F.R.D. 330, 336 (E.D.N.Y. 1987) (denying class certification due to post-revelation purchases by lead plaintiff, which "raise[d] individual reliance and materiality questions that make him unacceptable as a class representative"); *Greenspan v. Brassler*, 78 F.R.D. 130, 132-33 (S.D.N.Y. 1978) (denying motion for class certification because lead plaintiffs purchased stock after the fraud was revealed, which "raises questions concerning the materiality to them of the market's integrity and defendants' alleged misrepresentations").

Other courts have rejected this analysis. In *In re Electronic Data Systems Corp. Securities Litigation*, 226 F.R.D. 559 (E.D. Tex. 2005), a pension fund brought a class action against Electronic Data Systems based on allegations that EDS concealed problems that it was having in fulfilling a large contract to create an intranet for the United States Navy. The court found that the fact that the fund continued to purchase EDS stock after the problems were disclosed did not undermine its suitability as a class representative. It reasoned that the fund continued to purchase the stock because it "felt EDS stock had hit a bottom and was thus a good buy at that point in time," not because it was not relying on the integrity of the market price. "[A]lthough the securities were priced higher before the September 18th disclosures by EDS, both the high and low prices were assumed accurate since the stocks were traded on an efficient market" and the fund could still "plausibly believe that EDS stock remained a good bargain going forward since the lower price reflects new, and presumably accurate, information." 226 F.R.D at 565-66.

The court in *In re Frontier Insurance Group, Inc. Securities Litigation*, 172 F.R.D. 31 (E.D.N.Y. 1997) reached a similar conclusion. Investors in Frontier Insurance Group, an insurance holding company, brought a class action alleging that Frontier had concealed problems with high risk medical malpractice policies that it had been underwriting. One of the lead plaintiffs continued to purchase Frontier stock after the problems became public "because her husband 'felt that all the information had come out at that point and that he would try to recoup some of the money.'" The court found that "[t]he fact that [the lead plaintiff] attempted to recoup her losses by continuing to purchase Frontier stock after the disclosure of the alleged misrepresentations has no bearing on whether or not she relied on the integrity of the market during the class period." It therefore granted the plaintiffs' motion for class certification.[13] 172 F.R.D at 42.

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13. *See also Cosmas v. DelGiorno*, No. 94-cv-1974, 1995 WL 62598, at *4 (E.D.N.Y. Feb. 8, 1995) ("Cosmas attributes his purchase of additional stock after issuance of the Amended 8-K to an investment strategy, known as 'averaging down.' . . . The courts have recognized that the use of such an investment strategy does not create an atypical defense, or rebut the presumption of reliance in determining whether a class should be certified."); *Deutschman v. Beneficial Corp.*, 132 F.R.D. 359, 373 (D. Del. 1990) ("The fact that Deutschman may not have relied on the integrity of the market price of Beneficial stock on the later transactions does not mean that he cannot claim fraud on the market with regard to the earlier

C. Rebutting the Presumption for Day Traders

A third issue that has been litigated recently in the class certification context is whether day traders are entitled to the fraud-on-the-market presumption. Defendants have argued that the presumption should not be applied to day traders, because day traders rely on market volatility and small, technical movements in stock prices rather than on market integrity in determining what stocks to purchase. For the most part, this argument has been unsuccessful and courts have found day traders to be suitable class members and class representatives.

In *In re CMS Energy Securities Litigation*, 236 F.R.D. 338 (E.D. Mich. 2006), investors in CMS Energy alleged that the company had engaged in undisclosed, round-trip transactions with other energy companies to inflate revenue. The court rejected the defendants' argument that "day traders should be excluded from the Class because they do not trade in reliance on the market's integrity." It found that "a plaintiff who bought and sold in short order is similar enough to one who bought for the long term to be included in the class" and therefore "day traders are adequate class members and representatives."

Similarly, in *Taubenfeld v. Career Education Corp.*, No. 03-cv-8884, 2004 WL 554810 (N.D. ill. Mar. 19, 2004), investors in CEC, a for-profit postsecondary education provider, alleged that the company had concealed a number of problems with its schools bearing on their accreditation and graduation rates. In selecting a lead plaintiff, the court rejected the argument that "day traders may not be able to rely on the 'fraud on the market' theory of reliance." The court noted that a number of other courts had already considered the issue, and found day traders to be sufficiently typical of class members. Therefore "seeing no proof that [the day trader movant] is subject to unique defenses making him incapable of adequately representing the class, the challenge to his typicality is rejected." *Taubenfeld*, 2004 WL 554810 at *4.

In *Crossen v. CV Therapeutics*, No. 03-cv-3709, 2005 WL 1910928 (N.D. Cal. Aug. 10, 2005), investors in CV Therapeutics, a

transactions."); *Garfinkel v. Memory Metals, Inc.*, 695 F. Supp. 1397, 1404 (D. Conn. 1988) (rejecting argument that "because Goodwin purchased additional shares of Memory Metals . . . after the corrective press release was issued" he was an atypical class representative).

pharmaceuticals company, filed a class action for violations of Section 10(b) based on allegations that the company had misrepresented the safety and efficacy of an anti-anginal drug in development. The court rejected the defendants' argument that the lead plaintiff was atypical, and therefore an unsuitable class representative, merely because he had engaged in day trading. The court found that the "relevant question" was not whether the lead plaintiff was a day trader, but whether he "focused on 'technical[]price movements' [of the stock price] or on fundamentals and on defendants' statements in deciding whether to buy or sell." As the lead plaintiff had "testified that he focused on fundamentals, and defendants have not successfully rebutted the presumption, and his testimony, that he did" the court concluded that class certification was appropriate.[14] *Crossen*, 2005 WL 1910928 at *5.

One court, however, held that a day trader could not serve as a class representative. In *In re Safeguard Scientifics*, 216 F.R.D. 577 (E.D. Pa. 2003), discussed above with regard to post-revelation purchasers, the court found that "[i]n light of Lead Plaintiff Adal's employment as a day trader (or 'position trader') who typically focuses on technical price movements rather than price, we find that even under a fraud-on-the-market theory, Defendants have presented compelling reason to rebut the reliance presumption." 216 F.R.D. at 582. Similarly, in *Eichenholtz v. Verifone Holdings, Inc.*, No. C 07-06140 (MHP), 2008 WL 3925289 (N.D. Cal. Aug. 22, 2008),

14. *See also In re UTStarcom, Inc. Sec. Litig.*, No. 04-cv-4908, 2010 WL 1945737, at *7 (N.D. Cal. May 12, 2010) ("Plaintiff Weese's reliance on public information to build a long term position is sufficient to show him to be typical, notwithstanding whether he may be labeled a day trader."); *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 219 F.R.D. 343, 354 (D. Md. 2003) ("It has been suggested that Generic is atypical because it is a day-trader, and day-traders allegedly do not rely on the financial statements or the fundamental value of a company as the rest of the market does. But where false information and misleading omissions pollute the market, all types of investors are injured."); *In re Sunbeam Sec. Litig.*, No. 98-cv-8258, 2001 WL 899658, at *1 (S.D. Fla. July 3, 2001) ("Defendants argue that day traders . . . do not rely on the integrity of stock market prices, but rather are motivated by other trading strategies. I find this argument unpersuasive for purposes of fraud on the market analysis."); *Levie v. Sears Roebuck & Co.*, 496 F. Supp. 2d 944, 949 (N.D. Ill. 2007) ("[T]he court disagrees with defendants' position that . . . day traders . . . must be excluded from the class because they can not rely on the fraud-on-the-market theory. As noted above, any such trader who can establish injury as a result of the alleged fraud is properly included in the class definition.").

investors in Verifone Holdings filed class action lawsuits against the company. In selecting a lead plaintiff, the court found that one of the applicants was unsuitable because it was a day trader. "This day-trader would not be typical of the class because the class's damages stem from reliance upon the company's financial statements, not upon daily market volatility. Specifically, it may be subject to a unique defense regarding its reliance upon publicly available information." *Eichenholtz,* 2008 WL 3925289 at *11. However, the court did not expressly base this holding on the applicability of the fraud-no-the-market presumption to day traders. Rather, it seems to have concluded that the movant was unsuitable because its day trading would undermine any claim of direct reliance.

D. Rejection of Fraud-Created-the-Market and Integrity of Market Theories

Decisions by two Circuit Courts of Appeal have rejected efforts to expand the presumption of reliance at class certification. In *Malack v. BDO Seidman, LLP,* No. 09-4475, 2010 WL 3211088 (3rd Cir. Aug. 16, 2010), the court rejected the fraud-created-the-market theory as a basis for presuming reliance at class certification. The theory provides that investors may rely on the integrity of the market to the extent that securities offered for sale are entitled to be in the marketplace, and that a presumption of reliance is established where the plaintiff proves that the defendants fraudulently offered securities that were not entitled to be marketed. In *Malack,* the proposed plaintiff class had purchased short term notes that promised significantly above market interest rates that could be cashed in only upon maturity and with no market for resale. After the issuer went bankrupt, the plaintiffs filed suit against the issuer's outside auditor, alleging that had the auditors not offered clean audit opinions, the notes could not have been registered with the SEC and offered for sale. The district court denied the motion for class certification, rejecting the fraud-created-the-market argument and holding that the proposed class did not satisfy the predominance requirement of Rule 23.

In affirming denial of class certification, the Third Circuit acknowledged that some Circuit Courts had accepted the fraud-created-the-market theory.[15] The court, however, stated that "unmarketability" was an "elusive concept" that "lacks a basis in any

15. *See Shores v. Sklar,* 647 F.2d 462 (5th Cir. 1981(*en banc*).

of the accepted grounds for creating a presumption" of reliance. *Malack*, 2010 WL 3211088 at *4. The fraud-created-the-market theory, unlike the fraud-on-the-market theory, was not supported by empirical data or economic theory. Ironically, the court stated that there was no basis for relying on the integrity of the market to ensure the genuineness of securities, because all of the entities involved in marketing a security – including the underwriters, auditors and legal counsel – were self-interested, and the SEC could not be relied upon to prevent fraud because it does not conduct merit regulation. Further, the disclosure of adverse information might reduce the offering price, but not necessarily prevent a security from being marketed. In addition, the theory would unduly expand the scope of Section 10(b) and run afoul of the caution expressed by the Supreme Court, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* 552 U.S. 148 (2008), against expanding presumptions of reliance under the securities laws. For these reasons, the court joined the Seventh Circuit Court of Appeals in rejecting the fraud-created-the-market approach.[16]

In *Desai v. Deutsche Bank Securities Ltd.,* 573 F.3d 931 (9th Cir. 2009), the Ninth Circuit Court of Appeals addressed whether reliance may be presumed in a Section 10(b) action for purposes of class certification by investors who were allegedly harmed by a stock price manipulation. The district court denied the motion by the plaintiff class for certification under Rule 23(b) (3), ruling that individual questions of law or fact predominated over common ones because members of the plaintiff class would have to prove reliance on an individual rather than on a class-wide basis.

Plaintiffs argued on appeal that reliance could be presumed by all members of the plaintiff class because defendants had failed to disclose the stock price manipulation. Plaintiffs cited *Affiliated Ute Citizens v. U.S.,* 406 U.S. 128 (1972), which permits a presumption of reliance on omitted information that is material. The court held, however, that stock manipulation does not concern actionable omissions, but rather conduct that is intended to inflate the price of a security artificially by simulating market activity that does not reflect

16. *See Eckstein v. Balcor Film Investors,* 8 F.3d 1121 (7th Cir 1993). The *Malack* court left open the possibility of an action where an issuer had no legal right to issue a security, citing *T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.,* 717 F.2d 1330 (10th Cir. 1983) (bonds were issued in violation of state law because issuer was not a valid public trust).

actual investor demand. The court stated that because manipulative schemes inherently must be remain undisclosed in order to succeed, plaintiffs' argument would turn every stock manipulation into an omissions case, thereby transforming all of the Supreme Court's discussion as to what constitutes manipulative activity into a "completely, superfluous, intellectual exercise." 573 F.3d at 940-41.

Plaintiffs acknowledged that the market for the stock at issue was not efficient, precluding a presumption of reliance based on the fraud-on-the-market theory. Instead, plaintiffs asked the court to adopt an "integrity of the market theory," which would create a presumption of reliance whenever a stock price manipulation destroys the efficiency of a market and therefore reliability on the integrity of the stock price. Without analyzing the theory in detail, the court held that there was no authority requiring the district court to adopt plaintiffs' theory, and that therefore it had not abused its discretion in refusing to recognize it. *Id*. at 941-42.

II. THE STATUTE OF LIMITATIONS DEFENSE AFTER *MERCK & CO. v. REYNOLDS*

A. Conflicts Among the Circuit Courts

Private actions for securities fraud under Section 10(b) must be brought not later than the earlier of "(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation." 28 U.S.C. § 1658(b). The Supreme Court has long held that in the fraud context "discovery of the facts" generally includes both actual and constructive discovery. [17] As one lower court stated, if only actual discovery were required, investors could extend the time for filing suit simply by refusing to investigate possible fraud. *New England Health Care Emps. Pension Fund v. Ernst & Young,* 336 F.3d 495, 499-500 (6th Cir. 2003). Thus, an actual discovery standard would encourage "the opportunistic use of federal securities laws to protect investors against market risk; " investors could wait to see whether a poorly performing stock recovered, reap investment profits if it did, and sue for damages if it did not. *Id.* (citing *Treganza v. Great Am. Commc'n Co.,* 12 F.3d 717, 722 (7th Cir. 1993)).

17. *See, e.g., Bay Area Laundry and Dry Cleaning Pension Trust Fund v. Ferbar Corp. of Cal., Inc.,* 522 U.S. 192, 201 (1997); *Holmberg v. Armbrecht,* 327 U.S. 392, 397 (1946).

Prior to the Supreme Court's decision in *Merck & Co. v. Reynolds*, 559 U.S. ____,130 S. Ct. 1784 (2010) (hereinafter "*Merck*"), the Circuit Courts of Appeal had applied different standards with regard to when constructive discovery had occurred, and thus, when the 2 year period began to run. *Merck,* 130 S. Ct. at 1793. While almost every court proclaimed adherence to an "inquiry notice" standard, the precise interpretation of inquiry notice varied significantly.

At one end of the spectrum, the Eleventh Circuit Court of Appeal had held that the statute of limitations began to run when a plaintiff had "inquiry or actual notice of a violation." Inquiry notice was held to mean "knowledge of facts that would lead a reasonable person to begin investigating the possibility that his legal rights had been infringed." *Theoharous v. Fong,* 256 F.3d 1219, 1228 (11th Cir. 2001) (citation omitted).

On other end of the spectrum, the Sixth Circuit Court of Appeals held that knowledge of suspicious facts, or "storm warnings," put a plaintiff on inquiry notice, but such notice merely triggered a duty to investigate. The 2-year limitations period did not begin to run until a reasonably diligent investigation would have discovered the fraud. *New England Health,* 336 F.3d at 501. The Sixth Circuit formulation was shared by the Ninth and Tenth Circuit Courts of Appeal.[18]

In the middle, the Second Circuit Court of Appeal held, like the Sixth Circuit, that a duty to investigate was triggered "'when the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded.'" *Shah v. Meeker*, 435 F.3d 244, 249 (2d Cir. 2006) (quoting *Dodds v. Cigna Secs*., 12 F.3d 346, 350 (2nd cir. 1993). If a plaintiff made an inquiry, the Second Circuit followed the Sixth and held that the limitations period began to run on the date such inquiry, conducted with reasonable diligence, should have revealed the fraud. However, if the plaintiff failed to investigate, the Second Circuit followed the Eleventh Circuit and held that the statutory period began to run the date the duty of inquiry was triggered. *Shah v. Meeker,* 435 F.3d 244, 249 (2d Cir. 2006).

18. *Betz v. Trainer Wortham & Co., Inc.,* 504 F.3d 1017, 1024 (9th Cir. 2007), *vacated, Trainer Wortham & Co., Inc. v. Betz,* 130 S. Ct. 2400 (2010); *Sterlin v. Biomune Sys.,* 154 F.3d 1191, 1201 (10th Cir. 1998).

B. Background to *Merck*

Merck concerned the company's drug Vioxx, a pain suppressant that the Food and Drug Administration ("FDA") approved in 1999 for prescription use. In March 2000, Merck released a study that showed Vioxx had fewer gastrointestinal side effects than another painkiller, Naproxen, but that persons taking Vioxx had a greater incidence of heart attacks. Merck's press release asserted that these findings were consistent with Naproxen's ability to impede platelet aggregation, not because of any harm caused by Vioxx (the "Naproxen hypothesis").

The public debate concerning Vioxx continued to unfold during 2001. In May 2001, product liability suits were filed alleging that users of Vioxx were four times as likely to suffer heart attacks compared to other less expensive mediations. In August 2001, the Journal of the American Medical Association stated that data raised a "cautionary flag" concerning whether Vioxx increased the risk of heart attacks, while at the same time Merck stated that it stood behind Vioxx's safety. In September 2001, the FDA sent Merck a warning letter stating that Merck's advertising about Vioxx's cardiovascular risks was false and misleading. While the FDA acknowledged that the Naproxen hypothesis was plausible, it found that Vioxx had failed to disclose the equally plausible theory that Vioxx increased the risk of heart attacks. More product liability suits followed the disclosure of the FDA warning letter, while in October 2001 the *New York Times* reported that Merck again found no evidence that Vioxx increased heart attack risk.

Two years later, in October 2003, the *Wall Street Journal* published the results of a Merck-funded study that found that persons given Vioxx for 30-90 days were 37% more likely to have suffered a heart attack than those given a different painkiller or no painkiller. In September 2004, Merck withdrew Vioxx from the market, stating that a new study found an increased risk of heart attacks after 18 months of continuous use. On November 1, 2004, the *Wall Street Journal* reported that internal Merck emails and marketing materials as well as interviews with outside scientists showed that Merck had attempted for years to prevent safety concerns from destroying Vioxx's commercial prospects.

On November 6, 2003, plaintiffs filed a securities fraud complaint, which as amended, alleged that Merck had defrauded investors by promoting the Naproxen hypothesis, when Merck had known much earlier that Vioxx increased the risk of heart attack. Merck moved to dismiss on the ground that plaintiffs had known "the facts constituting the violation" at least two years earlier. The district court granted the motion, ruling that the FDA warning letter in September 2001 and Merck's October 2001 response placed plaintiffs on inquiry notice of a possible claim no later than October 9, 2001.

C. The Decision in the Court of Appeals

In *In re Merck & Co. Securities, Derivative & "ERISA' Litigation,* 543 F.3d 150 (3rd Cir. 2008), the Third Circuit Court of Appeals reversed the district court. The court held that the pre-November 2001 events, while constituting "storm warnings," did not suggest that Merck had acted with scienter, a required element of a Section 10(b) claim, and therefore did not put plaintiffs on "inquiry notice" requiring them to investigate further. Citing language from a decision by Seventh Circuit Court of Appeals, the court stated that "'[t]he facts constituting [inquiry] notice must be sufficiently probative of fraud — sufficiently advanced beyond the stage of a mere suspicion, sufficiently confirmed or substantiated — not only to incite the victim to investigate but also to enable him to tie up any loose ends and complete the investigation in time to file a timely suit.'" *Id.* at 164 (quoting *Fujisawa Pharm. Co. v. Kapoor,* 115 F.3d 1332, 1335 (7th Cir. 1997)).

D. Decision by the Supreme Court

The Supreme Court affirmed unanimously, in an opinion written by Justice Breyer, with concurring opinions by Justice Scalia (in which Justice Thomas joined in part) and Justice Stevens. Turning to the text of 28 U.S.C. § 1658(b), the Court held that "after the discovery of the facts constituting the violation" referred not only to those facts that a plaintiff actually knew, but also "those facts a reasonably diligent plaintiff would have known." *Merck*, 130 S. Ct. at 1787. The Court supported that holding by noting that after its decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson,* 501 U.S. 350 (1991), which applied to Section 10(b) the statute of limitations found in other limitations periods in the securities laws, every Court of Appeals to decide the question held that the discovery of facts triggering the limitations period occurred when a "hypothetical reasonably diligent plaintiff would have discovered them." *Merck*, 130 S. Ct. at 1788.

The Court rejected Merck's argument that the statute did not require discovery of scienter-related facts, holding that the discovery of "facts constituting the violation" means facts regarding all elements of the violation. The Court noted that a plaintiff cannot recover under Section 10(b) without proving that a defendant made a material misrepresentation or omission with an intent to deceive, and indeed, that in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308 (2007), the Court had held that a plaintiff must set forth facts in a complaint showing that it was more likely than not that the defendant acted with the relevant knowledge or intent. Thus it would frustrate the purpose of §1658(b), which specifically applied to fraud actions, if the limitations period began to run regardless of whether a plaintiff had discovered facts suggesting scienter. Additionally, the Court rejected Merck's argument that any material misstatement or omission should suggest scienter. Rather, the Court held that there must be some additional information that could lead a reasonable investor to conclude that the defendants acted with scienter. However, the Court noted that it was not opining about whether the limitations period began to run only when the plaintiff discovered other facts necessary to support a Section 10(b) action, citing the *Amicus Curiae* brief of the United States suggesting that facts concerning reliance, loss and loss causation are not among those that constitute the "violation" and therefore need not be discovered for the claim to accrue.

The Court held that inquiry notice is not sufficient to start the running of the limitations period to the extent it refers to a time prior to the plaintiff's discovery of facts showing scienter or other "facts constituting the violation." Rather, the 2 year limitations period begins to run "once the plaintiff did discover or a reasonably diligent plaintiff would have 'discover[ed] the facts constituting the violation' – whichever comes first." *Merck*, 130 S. Ct. a 1798. The Court rejected Merck's argument that such a standard was too complicated, observing that courts already had applied such an analysis and there was no showing that the precedent was unworkable. The Court did not entirely discard the use of such terms as "inquiry notice" and "storm warnings," stating that they may be useful to the extent that they "identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating." But the limitations period does not begin to run "until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation' irrespective of whether the actual plaintiff undertook a reasonably diligent investigation."

Applying the above analysis to the facts, the Court held that none of the pre-November 2001 events revealed facts indicating scienter. The FDA's September 2001 warning letter did not reveal scienter, given that the FDA had described the Naproxen hypothesis as a plausible explanation for why Vioxx had a greater incidence of heart attacks. Further, the various product liability actions lacked specific information suggesting that Merck knew that the Naproxen hypothesis was false. Thus prior to November 6, 2001, the plaintiffs did not discover, and Merck failed to show that a reasonably diligent plaintiff would have discovered, "the facts constituting the violation."

E. Post-*Merck* Decisions

The most immediate impact of *Merck* was on a companion case from the Ninth Circuit, *Trainer Wortham & Co., Inc v. Betz.,* 130 S. Ct. 2400 (2010). In that case, the plaintiff had received periodic account statements revealing a declining investment balance. The plaintiff did not investigate the matter based partly on assurances from the defendants that they would resolve the matter. The plaintiff did not bring suit until defendants stated they would not take any remedial action. The district court dismissed the action as time-barred under the inquiry notice standard. Reversing the district court, the Ninth Circuit rejected defendants' claims that the account statements were sufficient to put plaintiff on inquiry notice, holding that it was not clear as a matter of law that financial problems alone would put an investor on notice of scienter.[19] After the decision in *Merck,* the Court vacated the Ninth Circuit opinion, and remanded for reconsideration in light of *Merck*. The Ninth Circuit in turn remanded the matter to the district court for reconsideration.[20]

Given that *Merck* is so recent, its full impact is yet to be seen. Still uncertain is the continued vitality of the "inquiry notice" concept and how courts will decide when the hypothetical reasonably diligent plaintiff would have discovered sufficient indicia of scienter to trigger the limitations period. One district court cited *Merck* as additional support for its finding that claims under the Securities Act

19. *Betz v. Trainer Wortham & Co., Inc.,* 504 F.3d at 1026-27.
20. *Betz v. Trainer Wortham & Co., Inc.,* 610 F.3d 1169 (9th Cir. 2010).

of 1933 were not time barred.[21] Plaintiffs' claims alleging fraudulent conduct in connection with the sale of mortgage backed securities would have been time-barred had they discovered the facts constituting the violation prior to March 2008. The court held that it could not determine as a matter of law that the intense media scrutiny of mortgage backed securities throughout 2007 meant that plaintiffs should have discovered the facts underlying the alleged violations.

Another district court vacated a prior order dismissing Securities Act claims as time-barred because the order had cited and applied "inquiry notice" principles rejected by *Merck*. The court, however, reaffirmed the dismissal of the claims based on the limitations period set forth in the Securities Act.[22]

III. EXTRA TERRITORIAL APPLICATION OF THE SECURITIES LAWS AND THE *MORRISON* DECISION

The advent of globalization of the world financial markets announced the arrival of transnational securities fraud. The United States, with its unique class-action mechanism and fraud-on-the market theory eliminating the need to show individual reliance on a defendant's misstatements and omissions, has become the preferred forum for foreign and domestic plaintiffs trying to recoup losses in transnational securities transactions.

In recent years, one form of foreign litigation had become increasingly popular – the so-called "foreign-cubed" securities class actions, *i.e.*, private actions brought in the United States by foreign purchasers of securities issued by a foreign company that were traded on a foreign exchange. One study showed that approximately 12% of all securities actions filed in 2009 involved companies domiciled outside of the U.S.[23] A central issue that federal courts have addressed in such

21. *Pub. Emps. Ret. Sys. Of Miss. v. Merrill Lynch & Co., Inc.,* —- *F. Supp. 2d.* —-, 2010 WL 2175875 (S.D.N.Y. June 1, 2010). Outside the securities context, one district court applied *Merck* when construing the statute of limitations under the Comprehensive Environmental Response, Compensation, and Liability Act. The court held that under *Merck* that "discovery" included both actual and constructive discovery, and that constructive discovery occurred when a plaintiff, with ordinary diligence, should have discovered the facts of the violation.

22. *Sewell v. D'Allesandro and Woodyard, Inc.,* No. 2:07-cv-343-Ftm-29SPC (M.D. Fla. July 20, 2010)

23. *See* Kevin LaCroix, *More Thoughts About Morrison v. National Bank* (Jun 28, 2010) http://www.danodiary.com/2010/06/articles/securities-litigation/more thoughts about *Morrison* v. National Bank.

actions is the extraterritorial application of the federal securities laws. Although the financial stakes of class action litigation lawsuits are extremely high,[24] and the applicability of potentially conflicting foreign laws and regulations make foreign-cubed actions difficult to litigate and prone to nuisance settlements, courts have struggled to formulate a unified approach to the extraterritorial application of Section 10(b).

The Supreme Court finally weighed in on this matter in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), a sweeping decision that abrogated the approach and its variations that had been established over decades among the Circuit Courts of Appeal. The Court held that Section 10(b) of the Exchange Act applies only to transactions in securities that are listed on domestic exchanges and domestic transactions in other securities. In so holding, the Court, while affirming the Second Circuit's dismissal of a "foreign-cubed" securities class action, rejected the analysis utilized by the Second Circuit that was widely shared by the lower courts. That analysis, usually described as the conduct/effects test, permitted such lawsuits when the transaction had a substantial effect on the U.S. markets and/or citizens, or where significant fraudulent conduct occurred in the United States. The Court also rejected the notion that the extraterritorial reach of Section 10(b) concerns subject-matter jurisdiction rather than the scope of the statute itself. The decision is important not only because it ends nearly a half-century of speculation over the extraterritorial application of the United States securities laws, but also because it might signify the return of a very strict understanding of the presumption against extraterritoriality.

A. Background to *Morrison* Decision

Courts acknowledged that Section 10(b) of the Exchange Act "is silent as to its extraterritorial application."[25] But since at least 1968, based largely on policy considerations, they have read the Exchange Act as reaching some international transactions when the transactions had (1) a substantial effect on the U.S. markets or citizens; or (2) a significant fraudulent conduct occurred in the United States; or sometimes, (3) a combination or a variation of these two tests. Courts

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24. *See* Erez Reuveni, *Extraterritoriality as Standing: A Standing Theory of the Extraterritorial Application of the Securities Laws*, 43 U.C. Davis L. Rev. 1071, 1073, n.6 (April 2010) (citing statistics).
25. See *id*. at 1071; see also *Morrison*, 130 S. Ct. at 2878.

analyzed the issue of the extraterritorial reach of the Exchange Act as a question of subject matter jurisdiction over the underlying dispute.

- ***The Effects Test***

Under the "effects" test, the Exchange Act has been held to apply to foreign conduct that caused a substantial effect within the United States. *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2nd Cir. 1968). *Schoenbaum* concerned the sale in Canada of the treasury shares of a Canadian corporation whose publicly traded shares (but not its treasury shares) were listed on both the American Stock Exchange and the Toronto Stock Exchange. The Second Circuit held that "neither the usual presumption against extraterritorial application of legislation nor the specific language" in the Exchange Act showed Congressional intent to preclude application of the Exchange Act to transactions regarding stocks traded in the United States which are executed outside the United States, if such application was "necessary to protect American investors."[26] The Court relied on the Act's purpose to protect the interests of U.S. investors, the language of certain provisions of the Exchange Act, and the SEC's interpretation of the Act, to conclude that the statute applied extraterritorially if there was a substantial effect on U.S. investors. The court thus viewed the policies underlying the Exchange Act expansively, as concerned not only with the fairness of the transactions that take place on the U.S. markets but also with protection of the interests of U.S. investors in general.[27]

- ***The Conduct Test***

Under the "conduct" test, the Exchange Act was held to apply to conduct in the United States that directly caused losses to foreign investors. The conduct test was first fashioned by Judge Henry Friendly in *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326 (2nd Cir. 1972). In *Leasco*, the complaint alleged that that the defendants had engaged in fraudulent misrepresentations within the United States in order to induce the U.S. plaintiffs to purchase in London securities not listed on any of the exchanges in the United States. The Second Circuit held that

26. *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2nd Cir. 1968).
27. Hannah Buxbaum, *Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict*, 826 PLI/Lit 135, at 144-145.

the presumption against extraterritoriality was inapplicable when significant fraudulent conduct occurred in the United States: "when, as here, there has been significant conduct within the territory, a statute cannot properly be held inapplicable simply on the ground that, absent the clearest language, Congress will not be assumed to have meant to go beyond the limits recognized by foreign relations law."[28] Like *Schoenbaum*, the *Leasco* court justified its decision by the necessity of protecting U.S. investors: "Still we must ask ourselves whether, if Congress had thought about the point, it would not have wished to protect an American investor if a foreigner comes to the United States and fraudulently induces him to purchase foreign securities abroad – a purpose which its words can fairly be held to embrace."[29]

Later cases expanded the conduct test to apply to transactions that did not involve U.S investors, thus fashioning a new rationale to justify the application of the U.S. securities laws to transactions effectuated abroad – that of preventing the U.S. from becoming a "launching pad" for fraudulent behavior directed elsewhere.[30] The foreign-cubed cases are most often analyzed under the conduct test.[31]

- ***Other Tests***

The fluid nature of the criteria used in the conduct and effects tests and the amorphous policies behind them led to inconsistent and unpredictable application, and resulted in the creation of other derivative standards for the extraterritorial application of the securities laws.[32] Some courts created a hybrid test and allowed plaintiffs to establish the requisite ties with the United States by demonstrating some combination of "conduct" and "effects" within the United States.[33] Others went beyond the application of

28. *Leasco*, 468 F.2d at 1334.
29. *Id.* at 1337.
30. Buxbaum, *supra*, at 147-148.
31. Stephen J. Choi & Linda J. Silberman, *Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 Wis.L.Rev. 465, 466-68 (2009).
32. *See Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 665-67 (7th Cir. 1998) (describing the approaches of the various Circuits and adopting its own variation).
33. *See Itoba Ltd. v. Lep Gr. PLC*, 54 F.3d 118, 122 (2nd Cir. 1995) ("There is no requirement that these two tests be applied separately and distinctly from each other. Indeed, an admixture or combination of the two often gives a better picture

the conduct and effects tests and looked for additional "tipping factors" that would justify the exercise of jurisdiction in cases with predominantly foreign elements.[34] The result was that it became nearly impossible for foreign companies to predict their level of exposure to securities class action litigation in the United States, and some began to withdraw from the U.S. capital markets for that reason. That was the legal and business landscape in which *Morrison* was decided.

B. The *Morrison* Analysis of Section 10(b)

1. Background to Decision

Morrison was a classic foreign-cubed securities class action. National Australia Bank ("National"), an Australian bank whose "ordinary shares" (common stock) traded only in Australia, purchased HomeSide Lending, a mortgage servicing company headquartered in Florida. In 2001, National wrote down the value of the assets that it received in the HomeSide acquisition, which caused its share price to fall. Petitioners were Australians who purchased National's ordinary shares on the Australian market before the write-down. They sued National, HomeSide, and officers of both companies in U.S. federal court for violations of Section 10(b) of the Exchange Act, as well as Rule 10b-5 promulgated thereunder, claiming that HomeSide and its officers had manipulated financial models to make the company's mortgage-servicing assets appear more valuable than they really were, and that National and its chief executive officer were aware of this deception. The defendants moved to dismiss for lack of subject-matter jurisdiction under Federal Rule of Civil Procedure 12(b)(1) and for failure to state a claim under Rule 12(b)(6). The district court granted the motion, finding that it lacked jurisdiction because the only domestic acts alleged were at most a link in a securities fraud that was concluded abroad.[35]

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of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court.").

34. Buxbaum, *supra*, at 148-149.

35. *In re Nat'l Australia Bank Sec. Litig.*, No. 03 Civ. 6537(BSJ), 2006 WL 3844465, *8 (S.D.N.Y. Oct. 25, 2006).

The Second Circuit Court of Appeals affirmed on similar grounds.[36] The court observed that despite the difficulties presented by foreign-cubed actions, declining jurisdiction over such cases "would conflict with the goal of preventing the export of fraud from America." *Id*. at 175. The court rejected a bright-line approach to the extraterritorial application of Section 10(b) because it was impossible to "anticipate all the circumstances in which the ingenuity of those inclined to violate the securities laws should result on their being subject to American jurisdiction." *Id*. Applying the conduct test, the Court found that jurisdiction was lacking because the "fraudulent statements at issue emanated from NAB's corporate headquarters in Australia, the complete lack of any effect on America or Americans, and the lengthy chain of causation between HomeSide's actions and the statements that reached investors . . . ." *Id*. at 177.

2. *The Supreme Court's Decision*

In a unanimous ruling (8-0, as Justice Sotomayor recused herself), the Supreme Court agreed with the Second Circuit that the lawsuit should be dismissed. The Justices split 5-3, however, on the question of whether Section 10(b) has, at least under some circumstances, an extraterritorial reach. The majority opinion was authored by Justice Scalia, while Justice Stevens, joined by Justice Ginsburg, and Justice Breyer filed separate opinions.

- **The Extraterritorial Reach of Section 10(b) is a Question of Merit, not of Subject Matter Jurisdiction**

  The majority opinion first corrected a threshold error in the analysis of the Second Circuit, which considered the extraterritorial reach of Section 10(b) to be a question of subject-matter jurisdiction under Rule 12(b)(1). Justice Scalia pointed out that the question of what conduct Section 10(b) reaches is a question of merit and not of jurisdiction. The

36. *Morrison v. Nat'l Australia Bank Ltd.*, 547 F.3d 167, 175 (2nd Cir. 2010).

district court had jurisdiction to hear the case pursuant to Section 27 of the Exchange Act.[37]

There is indeed a distinct analytical difference between subject matter jurisdiction and the existence of a claim.[38] The former addresses a federal court's prescriptive jurisdiction, *i.e.*, the court's power to adjudicate a dispute under the Constitution. A court has that power so long as a plaintiff invokes a nonfrivolous federal cause of action. The latter addresses legislative jurisdiction, *i.e.,* Congress's intent for the relevant statute to reach extraterritorial conduct. This issue focuses on whether the cause of action exists in the first place or on whether a plaintiff has statutory standing to sue — both nonjurisdictional inquiries.[39] If a plaintiff fails to show that Congress intended to reach extraterritorial conduct, the proper action for the court is not to dismiss the claim for want of subject matter jurisdiction, but to decide the claim, ruling on the merits that the plaintiff has failed to state a cause of action under the relevant statute, or dismiss on the basis of the plaintiff's failure to establish statutory standing without reaching the merits. Thus the Court swiftly swept away a half-century of lower courts treating the issue of the extraterritorial reach of the securities law as a question of subject matter jurisdiction.

- **The Presumption Against Extraterritoriality**

The Court began its substantive analysis by restating the "longstanding principle of American law 'that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States,'" citing *EEOC v. Arabian American Oil Co*., 499 U.S. 244, 248 (1991) ("*Aramco*"). In *Aramco*, Chief Justice Rehnquist stated that the presumption was not a way to limit the powers of Congress, but a means to effectuate unexpressed Congressional intent.[40] The presumption thus achieved two

37. *Morrison*, 130 S. Ct. at 2877. The Court did not remand the case, finding that nothing in the analysis of the Second Circuit turned on that mistake and the correction would simply require a different statutory label on the dismissal. *Id*.
38. Reuveni, *supra*, at 1096-1100.
39. *Id.* at 1081.
40. *Aramco*, 499 U.S. at 247.

goals: (1) it avoided conflicts between U.S. laws and those of other nations; and (2) it provided a canon of statutory construction rooted in the notion that Congress legislates with primarily "domestic concerns" in mind. Overcoming the presumption required a clear expression of Congressional intent. Aramco, 499 U.S. at 247.

- **The Rejection of the Conduct and Effects Tests**

The Court severely criticized the Second Circuit for acknowledging that the Exchange Act was silent on extraterritoriality but declining to apply the presumption against extraterritoriality, instead attempting to ascertain the Congressional intent by means of the judicially created "conduct" and "effects" tests. The Court was scathing in its critique of the tests and its various derivations, finding them "complex in formulation and unpredictable in application." *Morrison*, 130 S. Ct. at 2878. Emphasizing the wisdom of the presumption against extraterritoriality, the Court found no clear evidence that Congress intended Section 10(b) to apply to foreign transactions and rejected plaintiffs' argument that a general reference in Section 10(b) to foreign commerce as part of the definition of "interstate commerce" was sufficient to overcome the presumption against extraterritoriality. Similarly deemed inadequate to defeat the presumption was the reference to the purpose of the Exchange Act as including the dissemination and quotation abroad of the prices of securities traded in domestic exchanges, and Section 30(b), which provides for the extraterritorial application of the Exchange Act to transactions abroad under certain limited circumstances. *Id*. at 2881-83

The second part of the Court's analysis addressed the question of what kinds and degree of domestic activity were sufficient to overcome the presumption because, in Justice Scalia's colorful language, "the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever *some* domestic activity is involved in the case." *Id*. at 2884. The Court found that the answer lies in the type of conduct that Congress enacted the federal statute at issue to regulate. The Court observed that Section 10(b)'s language prohibiting deceit "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered" focuses not on the *locus* of the fraudulent activity, but on where the "purchase or sale" of securities occurred. By its own terms, the statute meant to protect the parties or the prospective parties to these transactions, and not deceptive conduct in general. The Court concluded that only transactions in securities listed on domestic exchanges, and domestic transactions in other securities were within the scope of Section 10(b). *Id*. at 2884-85.

Further, the Court rejected an alternative "significant and material" conduct test that was suggested by plaintiffs and the Government, which filed an *amicus* brief. The test would have found a violation of Section 10(b) if the transnational securities fraud involved significant conduct in the U.S. that was material to the fraud's success. The test was thus broader than the transactional test adopted by the Court because it would have brought within the SEC's authority foreign transactions in securities that were not listed on U.S. exchanges. The Court found that the proposed test lacked any textual support and failed to satisfy the "in connection with" requirement of Section 10(b). *Id*. 2886-87.

Echoing the concerns expressed in *Aramco,* the Court further noted that opening the doors to private shareholder litigation under Section 10(b) based on foreign securities transactions would present a high probability of conflict with the applicable laws of other countries, as was argued in *amicus* briefs submitted to Australia, the United Kingdom, France and a number of international organizations. *Id*. 2885-86.

Justice Stevens argued in his concurring opinion that the majority's conclusion that the Exchange Act did not apply extraterritorially and its rejection of the conduct/effects test was not necessary in light of the majority's finding that Section 10(b) by its own terms applied to only domestic transactions. The majority disagreed, pointing out that without the presumption, Section 10(b) would have applied to all fraudulent transactions in stock regardless of the *situs* of the purchase or sale of the securities. *Id*. 2884, n.9. Because the Court's new transactional test limits the categories of the transactions protected by Section 10(b), Justice Stevens characterized the Court's decision as one more step in the

Court's "continuing campaign to render the private cause of action under Section 10(b) toothless." *Id*. 2895. Responding to this criticism, Justice Scalia noted that "[w]hile there is no reason to believe that the United States has become the Barbary Coast for those perpetrating frauds on foreign securities markets, some fear that it has become the Shangri-La of class-actions litigation for lawyers representing those allegedly cheated in foreign securities markets." *Id*. 2886 (Stevens, J., concurring).

C. The Impact of *Morrison*

The most immediate impact of *Morrison* might very well be on pending litigation in the federal courts involving plaintiff classes that include foreign investors who purchased the securities of foreign-domiciled companies on foreign securities markets. Such litigation includes pending actions against Vivendi, BP, Porsche and Toyota. The courts likely will be required to limit eligible class members to those who purchased American Depository Receipts ("ADRs") on U.S. exchanges, which would greatly reduce the potential recovery. In several actions, foreign class members are being voluntarily removed from the class.[41]

Under the Court's new transactional test, only transactions in securities listed on domestic exchanges or domestic transactions in other securities are subject to Section 10(b). The Court's decision will thus foreclose certain securities fraud actions that would have been actionable prior to *Morrison* if the court found sufficient U.S. conduct or effect. Among others, "foreign-cubed" securities class actions are foreclosed because such actions involve neither securities

41. *See In re Vivendi Universal SA Sec. Litig.,* No. 02-05571 (S.D.N.Y.) (hearing on July 26, 2010 concerning Vivendi's request to reduce multi-billion dollar verdict rendered in January 2010); *Elliot Assoc. L.P. v. Porsche Auto. Holding SE,* No. 1:10-CV-00532-HB (plaintiffs voluntarily dismissed certain foreign plaintiffs from complaint); *Stackhouse v. Toyota Motor Co.,* CV-10-0922, 2010 WL 3377409, *1 (C.D. Cal. July 16, 2010) (minute order) (expressing inclination to appoint as lead plaintiff investor with largest alleged ADR loss, stating that *Morrison* likely precluded claims based on purchases or sales of securities by U.S. investors on foreign exchanges not explicitly solicited by foreign issuer in the United States); *Cornwell v. Credit Suisse Group,* —- F. Supp. 2d —-, 2010 WL 3069597, *2-6 (S.D.N.Y. July 27, 2010) (dismissing claims by plaintiffs who purchased shares of Credit Suisse Group AG on the Swiss Stock Exchange based on *Morrison*).

listed on a U.S. exchange nor other securities purchased in the United States. One analysis estimated that at least 10% of the securities actions that were settled in 2009 could not have been brought in the U.S. or would have settled for much small amounts if the *Morrison* standard had been in effect.[42] The decision, however, does not affect foreign companies whose shares are traded on U.S. exchanges or who engage in the purchase or sale of securities in the United States. The decision also does not affect trading in ADRs listed on domestic exchanges.

Morrison, however, still leaves unresolved issues:

- ***When are Transactions "Domestic?"***

First, the Court's transactional test might not be as easy to apply as it appears. The test clearly brings within the statute's meaning transactions in securities listed on U.S. stock exchanges. The issue is more complicated with respect to domestic transactions in stock not listed on U.S. exchanges, because it requires a determination of when a transaction is domestic and when it is foreign. This determination might not be easy to make in today's world of transnational finance and technologically linked market places. For example, does the trade qualify as a domestic transaction where the order to buy stock is placed by a foreign investor to a foreign brokerage firm, who instructs its U.S. affiliate to buy stock in the United States? What about purchases by U.S. investors of foreign securities over the internet from web sites maintained outside the U.S.?[43] Does *Morrison* mean that U.S. citizens who purchase foreign securities on foreign exchanges must seek any redress in foreign courts, and not in the U.S.? What if a foreign investor calls a broker in the United States and places an order for stock traded on a foreign exchange?

There are no easy answers to these questions. One way the courts might address this issue is by reference to conflict of laws principles, according to which the place where a contract occurred is generally the location of the last act necessary to execute the

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42. *See* Luke Green, The *Dawn of a New Age* (Jun 25, 2010, 5:54pm), http://blog.riskmetrics.com/slw/2010/06/*Morrison*-v-National-Australia-Bank – The Dawn of a New Age?
43. *See* Margaret Sachs, *International Securities Fraud Makes Supreme Court Debut*, available at http://opiniojuris.org/2010/06/25/morrison-and-the-presumption-against-extraterritoriality/.

contract under the law of the forum that is necessary to give a contract binding effect.[44] One court suggested that under the new standard, a U.S. resident located in the U.S. purchasing stock listed only on a foreign exchange "has figuratively travelled to that foreign exchange – presumably via foreign broker – to complete the transaction."[45]

Issues like the presence of foreign plaintiffs in a class might also be addressed at other procedural stages of class-action litigation. Thus, when the lead plaintiff moves for class certification, it must meet Federal Rule of Civil Procedure 23 requirements of numerosity, commonality, typicality and adequacy of representation. Satisfying these criteria may be difficult in multinational class actions with regard to foreign plaintiffs where different legal standards might apply to domestic-based claims and those of foreign investors. Administrators of class action settlements might require proof of where each investor resided at the time the security was purchased and the exchange on which it was purchased. There might also be issues of availability of the fraud-on-the-market reliance theory to foreign plaintiffs and the potential lack of preclusive effect of settlement reached in the U.S. in other countries. Foreign plaintiffs might also face difficulties in being appointed as lead plaintiffs.[46] Further, a doctrine of *forum non convenience* separately gives the courts the power to dismiss the case if plaintiffs have an adequate alternative forum in their home courts.[47] *Morrison* is also significant because it touched

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44. *See* Williston on Contracts § 51:1 (Agreements for the purchase and sale of shares of stock and other securities are governed by the same legal principles as affect contracts generally); Restatement (Second) of Conflict of Laws, § 188. Note that under *Morrison*, the proper focus is not on the place where the deception occurred, but on the place of purchase or sale.
45. *Stackhouse,* 2010 WL 3377409 at *1. *See also Quail Cruises Ship Mgmt. Ltd. v. Agnencia de Viagens CVC Tur Limitada*, —- F. Supp. 2d —-, 2010 WL 3119908, *2-3 (S.D. Fla. Aug. 6, 2010) (choice of U.S. law in stock transfer agreement and choice of U.S. location for closing insufficient to make purchase or sale of stock domestic).
46. *See* Buxbaum*, supra,* at 151-52.
47. *See In re European Aeronautic Defence & Space Co. Sec. Lit.*, 2010 WL 1191888, at *9 (S.D.N.Y. March 26, 2010) (court declined jurisdiction where U.S. investors bought stock not listed on U.S. exchanges abroad because the transactions did not satisfy neither conduct nor effect tests, and where the doctrine of *forum non conveniens* separately supported the dismissal). *see also In re Banco*

upon the very meaning of the presumption against extraterritoriality and the type of evidence sufficient to overcome it. The Court's decision seems to indicate the return to the strict presumption formulated in *Aramco* that cannot be overcome by evidence of domestic conduct or effects,[48] and where the domestic conditions are determined by reference to the *locus* of the violation.[49] If that is true, securities law is not the only area that may be affected.[50]

- ***Lack of Protection of U.S. Legitimate Interests***

The critics of the bright-line territorial approach argued that there might be legitimate U.S. interests that would not be accommodated by the Court's transactional test. Justice Stevens joined by some commentators invoked a parade of horribles that would result from the Court's decision. Indeed, the transactional test would foreclose not only Foreign Cubed transactions but also "Foreign Squared" transactions, *i.e.*, transactions involving U.S. investors buying stock of a foreign company listed abroad. It also leaves unprotected foreign citizens trading abroad who are victims of domestic conduct perpetrated by Americans over whom the

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Santander Sec. Optimal Litig., —- F.Supp.2d —-, 2010 WL 3036990 (S.D.Fla. July 30, 2010).

48. Indeed, there is no one definition of the presumption against extraterritoriality. *See* William S. Dodge, 16 Berkeley J. Int'l 85, 1998. And neither *Schoenbaum* (establishing the effects test) nor *Leasco* (establishing the conduct test) have completely ignored it. In both cases, the courts considered the presumption, but did not give it much weight. The courts found sufficient evidence in the language of the statute and other indicia to conclude that the presumption could be overcome under certain circumstances.
49. In distinguishing *Pasquantino v. U.S.*, 544 U.S. 349 (2005), cited by the Government in support of the "significant and material" conduct test, the Court noted that the offense as defined by the wire-fraud statute at issue was complete once certain acts were accomplished in the United States and therefore the presumption did not apply. *Morrison*, 130 S. Ct. at 2887. In *Aramco*, by contrast, the presumption was not overcome because the *locus delicti* was abroad. The Court's rejection of the Government's "substantial and material" conduct test because neither the conduct nor the effects in the United States are part of the statutory definition of domestic conditions in the Exchange Act also supports this interpretation.
50. *See e.g., Cedeno v. Intech Group, Inc.*, —- F. Supp. 2d —-, 2010 WL 3359468, *2 (S. D. N. Y. Aug. 25, 2010) ("The RICO statute is silent as to any extraterritorial application, and so, under *Morrison*, is presumed not to apply to RICO claims that are extraterritorial in focus") (internal citations omitted).

foreign forum might lack personal jurisdiction. Foreign courts might also decline to hear the case with strong ties to the U.S on *forum non conveniens* grounds, creating a legal vacuum.

- ***The SEC's Authority Over Foreign Transactions in Securities not Listed on U.S. Exchanges is Nullified***

Another unsettled issue is the effect of the Court's decision on the SEC's enforcement powers under Section 10(b). While Justice Steven's concurrence suggests that the SEC's powers are untouched, this conclusion is questionable because both the presumption of extraterritoriality and the text of Section 10(b) apply as much to the government as they do to private parties.

The decision thus likely limits the SEC's enforcement powers to domestic transactions and transactions in stock listed on U.S. exchanges. It presumably invalidates preliminary note 1 to Regulation S of the Securities Act of 1933 (the Securities Act), in which the SEC appears to reserve the authority to apply the antifraud provisions of the federal securities laws in offerings made outside the United States under that regulation.[51] This result also means that there will be actions involving foreign securities fraud that the SEC would have no powers to prosecute, but that the U.S. criminal prosecutors would be able to reach under mail and wire fraud statutes.

On July 15, 2010 Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which was signed into law by President Obama on July 21, 2010. The relevant provisions of the Dodd-Frank Act, drafted in anticipation of the *Morrison* decision, authorize the federal courts to exercise jurisdiction over an action or proceeding brought or instituted by the SEC under Section 17(a) of the Securities Act, the antifraud provisions of the Exchange Act (including Section 10(b)), or Section 206 of the Investment Advisors Act, involving:

- conduct within the United States that constitutes significant steps in furtherance of the violations, even if the transaction occurs outside the United States, and involves only foreign investors; or

51. Regulation S provides: "1. The following rules relate solely to the application of Section 5 of the Securities Act of 1933 (the "Act") [15 U.S.C. 77e] and not to antifraud or other provisions of the federal securities laws."

- conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

The legislation also directs the SEC, within eighteen months after enactment, to conduct a study as to whether the conduct/effect test should be expressly extended to private rights of action under the antifraud provisions of the Exchange Act.

It is unclear, however, whether Dodd-Frank will effectively reverse *Morrison* because the Court held that the controlling issue is not the jurisdiction of the federal courts to hear such actions, but the fact that Section 10(b) itself does not provide for relief for extraterritorial claims. To bring the extraterritorial conduct within the scope of the SEC's powers under Section 10(b), Congress would have to amend Section 10(b) itself. On the other hand, courts may conclude that despite the express reference to the "jurisdiction" of the courts to hear a case under the Act, the legislation sufficiently reflects congressional intent to apply the Exchange Act extraterritorially with respect to actions by the SEC pursuant to Section 10(b) and the other provisions identified in the Dodd-Frank Act (although an "act of congress ought never to be construed to violate the law of nations if any other possible construction remains").[52] (citations omitted)

IV. REACTION TO SUPREME COURT DECISIONS IN *CENTRAL BANK* AND *STONERIDGE*

The United States Supreme Court, in two major decisions affecting the federal securities laws, has emphasized how the "reliance" element of a claim brought under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, severely limits the scope of such a claim. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994) ("*Central Bank*") and *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) ("*Stoneridge*"). Both *Central Bank* and *Stoneridge* have the effect of restricting Section 10(b) and Rule 10b-5 claims so that they do not reach those secondary actors who did not have direct interaction with investors. Recent decisions by the Circuit Courts of Appeals, however,

52. *See Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 815 (1993) (Scalia, J., dissenting.)

have differed on the application of these decisions while still leaving significant issues unresolved.

A. *Central Bank* and *Stoneridge*

Central Bank — this decision arose from a public housing authority's issuance of $26 million in bonds, for which the Central Bank of Denver served as the indenture trustee. After the bonds defaulted, The First Interstate Bank of Denver and an individual, who together had purchased $2.1 million in bonds, brought a Section 10(b) claim against the housing authority, the bond underwriters and Central Bank. The plaintiffs alleged that Central Bank was liable for aiding and abetting the purported fraud. The district court granted summary judgment for Central Bank, but the Tenth Circuit Court of Appeals reversed, holding that there was sufficient evidence to find that Central Bank was aware of inaccuracies in the appraisal of land that served as collateral for the bonds.

Central Bank sought review by the Supreme Court as to whether it could have aiding and abetting liability based on the underlying facts. The Court, however, *sua sponte* directed the parties to address whether aiding and abetting liability existed under Section 10(b), even though the parties had not raised that issue and all eleven Circuit Court of Appeals to consider the matter had recognized aiding and abetting liability. *See* 511 U.S. at 193-95 (Stevens, J., dissenting). In a 5-4 vote, with Justice Kennedy writing for the majority, the Court held that the text of Section 10(b) did not provide for aiding and abetting liability. Further, from the fact that Congress did not attach aiding and abetting liability to any of the express causes of action in the securities laws, the Court inferred that Congress likely would not have attached aiding and abetting liability to Section 10(b) if it also had been provided as an express cause of action. In rejecting the policy arguments supporting aiding and abetting liability urged by the SEC, the Court observed that uncertainty concerning the scope of aiding and abetting liability would engender litigation costs and coerced settlements.

The Court cautioned that: "The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the [S]ecurities Acts" because any person "who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities *relies* may be liable as a primary violator under 10b-5 . . . ."

(emphasis added). 511 U.S. at 191. Thus the Court emphasized the need reliance by an investor on the deceptive act or misstatement in order for Section 10(b) liability to arise.

Stoneridge — After *Central Bank* scuttled aiding and abetting liability, the focus shifted to the scope of primary liability in a Section 10(b) claim. Plaintiffs urged the courts to accept "scheme liability," in which all those who were involved in an effort to deceive investors would be held liable under Section 10(b) and Rule 10b-5 even if they had not made any materially false or misleading statements. The Supreme Court's decision in *Stoneridge* imposed severe, if not altogether crippling, limitations on such an argument by focusing on whether investors had relied on the statements or conduct of the defendant in making an investment decision.

Stoneridge concerned a class-action lawsuit by shareholders of Charter Communications, Inc., against Scientific-Atlanta, Inc. and Motorola, Inc. for allegedly engaging in a series of fraudulent transactions with Charter. Plaintiffs alleged that Charter agreed to overpay by $20 each of the cable converter boxes that it purchased from Scientific-Atlanta and Motorola with the understanding that Scientific-Atlanta and Motorola would return the overpayment by purchasing advertising from Charter. Because Charter recorded the advertising as revenue but capitalized the cost of the converted boxes, Charter was able to inflate revenue and cash flow in its financial reports. Plaintiffs alleged that Scientific-Atlanta and Motorola were liable to Charter's investors under a "scheme liability" theory.

The Eighth Circuit Court of Appeals affirmed dismissal of the claim on the ground that only misstatements or omissions by one with a duty to disclose could be "deceptive" within the meaning of Section 10(b).[53] The Supreme Court, with Justice Kennedy again writing the majority opinion in a divided Court (5-3 with Justice Breyer not taking part), affirmed the result but rejected the analysis of the Circuit Court, expressly holding that deceptive conduct could create liability under Section 10(b) even in the absence of oral or written statements. 552 U.S. at 158. Rather, the Court held that Scientific-Atlanta and Motorola could not be liable under Section 10(b) because there was no allegation that any of their actions or statements were relied upon by Charter's investors. As the Court stated:

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53. *In re Charter Commc'ns, Inc. Sec. Litig.,* 443 F.3d 987 (2006).

> Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action. It ensures that, for liability to arise, the "requisite causal connection between a defendant's misrepresentation and a plaintiff's injury" exists as a predicate for liability.

Id. at 159. (citations omitted). The Court stated that it had found a rebuttable presumption of reliance only where there was an omission of a material fact by one with a duty to disclose – the *Affiliated Ute* decision — and under the fraud-on-the-market doctrine, based on the assumption that public information is reflected in the market price of a security. But neither presumption applied, because the respondents had no duty to disclose to Charter's investors and their alleged deceptive acts were never communicated to the public. *Id*. The Court further stated that respondents' deceptive acts, which were not disclosed to the investing public, were too remote to satisfy the requirement of reliance. The Court also emphasized that accepting plaintiffs' theory would effectively revive aiding and abetting liability that had been rejected in *Central Bank,* even though Congress, in enacting the Private Securities Litigation Reform Act of 1995, had restored aiding and abetting liability for SEC actions but not in private shareholder actions. *Id*. at 161-62. As it did in *Central Bank,* the Court stated that Section 10(b) continued to apply to secondary actors who commit primary violations. However, the Court emphasized that it was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing that respondents did made it necessary or inevitable for Charter to record the transactions as it did. Thus Charter's investors could not be said to have relied upon any of respondents' deceptive acts in the decision to purchase or sell securities, and respondents had no liability to them. *Id*. at 166-67.

B. Responses of Circuit Courts of Appeal

Following *Stoneridge,* the Circuit Courts of Appeal have taken divergent roads in determining the scope of primary liability in light of the Supreme Court's focus on reliance as the touchstone of a Section 10(b) action.

- **Second Circuit –** In *PIMCO v. Mayer Brown LLP,* 603 F.3d 144 (2d Cir. 2010), the Second Circuit Court of Appeals held that secondary actors may be held liable under Section 10(b) only for those allegedly false statements that are explicitly attributable to them, and that the mere identification of the secondary actor as being involved in a transaction, or the public understanding that the secondary actor was at work "behind the scenes," was insufficient. 603 F.3d at 155. Thus the court held that a law firm could not be liable for allegedly drafting false and misleading statements in an offering memorandum and registration statements that were used in securities offerings by Refco, Inc., which had engaged in numerous sham transactions to disguise its deteriorating financial condition before filing for bankruptcy. The court rejected a so-called "creator" standard urged by the SEC that would impose liability for creating a false statement on which investors relied, regardless of whether the statement was attributed to the defendant at the time of dissemination. *Id*. at 156-58.

The court held that the attribution standard was consistent with *Stoneridge*'s emphasis on reliance as "the critical element in private actions under Rule 10b-5" and the "bright line" approach favored in previous Second Circuit decisions. The "creator" standard, however, would be indistinguishable from a "substantial participation" test rejected in the Second Circuit; increase the difficulty of differentiating primary from aiding and abetting liability; and create uncertainty in its application. *Id*. at 155-57. The court acknowledged that prior decisions of the Second Circuit suggested uncertainty as to whether those outside the corporation, such as auditors, do not have primary liability for drafting, editing or reviewing statements that are not specifically attributed to them, *Lattanzio v. Deloitte & Touche LLP,* 476 F.3d 147 (2d Cir. 2007), while a corporate insider engaging in such conduct may incur liability for misstatements by the corporation even though none of the statements were directly attributable to him, *In re Scholastic Corp. Sec. Litig.,* 252 F.3d 63 (2d Cir. 2001). The court stated that because the matter at hand did not concern claims against corporate insiders, it did not have to determine whether attribution was required for such claims, noting that "there may be a justifiable basis for holding that investors rely on the role corporate executives play in issuing public statements even in the absence of explicit attribution." 603 F.3d at 154, 157-58 and n.6. The court also rejected plaintiffs' theory of "scheme liability" under Rule 10b-5(a) and (c) as inconsistent with *Stoneridge*'s holding that the mere fact that a secondary actor's deceptive conduct was transmitted to the public through the issuer's financial statements was insufficient to show the required reliance for a Section 10(b) action.[54] *Id*. at 158-60.

- **Fourth Circuit** – The Fourth Circuit adopted what may be described as a modified attribution requirement in *In re Mutual Funds Investment Litigation,* 566 F.3d 111 (4th Cir. 2009). Shareholders of Janus Capital Group Inc. ("JCG") filed a complaint against JCG and its wholly-owned subsidiary, Janus Capital Management LLC ("JCM"), which was the investment advisor to the Janus mutual funds. Plaintiffs alleged that JCG and JCM were responsible for false statements included in individual Janus Fund prospectuses that the funds would not engage in market timing or excessive trading. The court declined to follow the Second and Eleventh Circuits by adopting a direct attribution test for pleading reliance in a Section 10(b) action. Instead, the court held that the attribution determination is to be made on a case-by-case basis "by considering whether interested investors would attribute to the defendant a substantial role in preparing or approving the allegedly misleading statement." 566 F.3d at 122-24.

  With respect to JCM, the court held that because investment advisers generally dominate the funds that they advise and in light of JCM's publicly disclosed responsibilities in managing the Janus funds, "interested investors would infer that JCM played a role in preparing or approving the content of the Janus fund prospectuses, particularly the content pertaining to the funds' policies affecting the purchase or sale of shares." *Id*. at 125-27. The court held that this result was fully consistent with *Stoneridge* because *Stoneridge* concerned deceptive acts – those of Scientific-Atlanta and Motorola – that were never publicly disclosed, and therefore the holding "has no application to a situation in which the allegedly misleading statements are indisputably public and the inquiry is focused solely on whether the investing public would have attributed a particular statement to a particular defendant." *Id*. at 127. However, the court held

54. In a pre-*Stoneridge* case, the Eleventh Circuit held that in light of *Central Bank*, there could not be liability under Section 10(b) and Rule 10b-5 unless the alleged misstatement or omission on which the plaintiff relied was publicly attributable to the defendant at the time of the plaintiff's investment decision. *Ziemba v. Cascade Int'l, Inc.,* 256 F.3d 1194, 1205-06 (11th Cir. 2001).

that JCG could not have Section 10(b) primary liability because it would not be apparent to an interested investor that the investment advisor's parent company would be involved in drafting or approving prospectuses issued by the individual funds. Nonetheless, the court held that JCG could be held liable as a control person under Section 20(a) of the Exchange Act. Id. at 127-28, 129-30.

- **Seventh Circuit** — In *Pugh v. Tribune Co.,* 521 F.3d 686 (7th Cir. 2008), plaintiffs alleged that employees of a subsidiary of the Tribune Company falsely inflated the circulation of two newspapers, Newsday and the Spanish-language Hoy, in order to increase the amount charged to advertisers, thereby boosting revenue. Among the defendants was Sito, who had been Hoy's President, publisher and chief executive, and the Tribune's vice-president for Hispanic Media. Plaintiffs alleged that Sito was the "mastermind" of the scheme to defraud advertisers and that it was "foreseeable" that the resulting improper revenue at Hoy would be reflected in the Tribune Company's financial statements. The court held that such allegations of "scheme liability" were insufficient under *Stoneridge.* Like the defendants in *Stoneridge,* Sito's alleged deceptive acts were never communicated to investors and he played no role in preparing or disseminating the Tribune Company's financial statements. However, rather than focus on reliance as did *Stoneridge,* the *Pugh* court held that plaintiffs failed to establish the requisite "proximate relation" between the fraud on the Newsday and Hoy advertisers and the harm to Tribune investors. 521 F.3d at 696-97. The court also refused to impute Sito's conduct to the Tribune Company itself. *Id*. at 698.

- **Ninth Circuit** – The test in the Ninth Circuit still formally remains the standard set forth in *In re Software Toolworks Inc. Sec. Litig.,* 50 F.3d 615 (9th Cir. 1994). Plaintiffs alleged, among other things, that a company's outside accountants violated Section 10(b) by participating or drafting two letters that allegedly contained false statements that the company sent to the SEC in connection with a public offering of securities. The court stated that the accountants had primary liability under Section 10(b) because one letter was prepared "after extensive review and discussions" with the accountants and the accountants "played a significant role in drafting and editing" the other letter.

50 F.3d at 628-29 and n.3. *See also Howard v. Everex Sys., Inc.,* 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) ("substantial participation or intricate involvement in the preparation of fraudulent statements" is sufficient to establish primary Section 10(b) violation).

Software Toolworks was decided more than 13 years before *Stoneridge* and it is dubious that its "substantial participation" test for determining primary liability under Section 10(b) remains valid in light of *Stoneridge*. The letters sent to the SEC were never disclosed publicly and the accountants' involvement in reviewing, editing or drafting those letters was never disclosed. Thus investors could not have relied upon any deceptive conduct by the accountants in making an investment decision concerning the securities being offered. The substantial participation test articulated in *Software Toolworks* was expressly rejected by the Second Circuit in *PIMCO,* 603 F.3d at 156; and the Fourth Circuit in *Mutual Funds,* 566 F.3d at 123. Two pre-*Stoneridge* decisions, *Anixter v. Home-Stake Production Co.,* 77 F.3d 1215, 1226 n.10 (10th Cir. 1996) and *Ziemba,* 256 F.3d at 1205, already had rejected the "substantial participation" test as inconsistent with *Central Bank.*

Although the *Software Toolworks*' "substantial participation" test has not been formally repudiated by the Ninth Circuit, a recent decision suggests that it has no longer has continuing validity. In *In re Peregrine Systems, Inc. Securities Litigation,* 310 Fed. Appx. 149 (9th Cir. 2009), plaintiffs alleged that the company's outside auditors agreed to purchase the company's software at the end of fiscal quarters in so-called "parking" transactions, allowing the company to meet its quarterly projections, in exchange for the auditors obtaining service contracts with the company's end users to whom the software ultimately would be sold. Affirming the dismissal of the claims against the auditors, the court held that under *Stoneridge* such transactions could not form the basis of Section 10(b) liability unless the investing public had knowledge of and relied upon the accountants' deceptive acts. 310 F.3d at 150-51. The court rejected the plaintiffs' argument that press releases referencing a partnership between the company and the auditors were sufficient to demonstrate reliance under the fraud-on-the-market presumption because the releases did not communicate any information concerning the so-called "parking" transactions in order to trigger the presumption. *Id*. at 151. As with *Stoneridge,* it was the company, not the outside entity, that filed fraudulent financial statements, and nothing the auditors did "made it necessary or inevitable" for the company to record transactions improperly. *Id*. at 151-52. Although the court did not reference *Software Toolworks,* the analysis in *Peregrine* would seem to reject the "substantial participation" test as a basis for Section 10(b) liability. At least one district court in the Ninth Circuit ignored the *Toolworks* test in light of *Stoneridge*. *See In re Downey Sec. Litig., No. CV 08-3261 (JFW)(RZx),* 2009 WL 736802, at * 5-6 (C.D. Cal. Mar. 18, 2009) (citing *Stoneridge,* dismissing Section 10(b) claims against corporate insiders where no actionable misrepresentation was attributable to them).

- ***SEC v. Tambone,* 597 F.3d 436 (1st Cir. 2010) (*en banc*)** – Although this decision did not arise from a private shareholder action, and therefore reliance was not an issue for the SEC, the court did examine the scope of Section 10(b) primary liability. The SEC alleged securities law violations by two executives of a registered broker-dealer that had been the principal underwriter and distributor of over 140 mutual funds. The SEC alleged that the funds' prospectuses contained false and misleading statements concerning the practice of market timing. The SEC further alleged that the defendants had primary liability under Rule 10b-5 by impliedly making false representations to investors that they had a reasonable basis for believing that the statements concerning market timing were truthful. The district court dismissed the SEC dismissed the claims, but a divided panel of the First Circuit reversed the dismissal of the claims under Section 17(a) of the Securities Act of 1933, Section 10(b), and for aiding and abetting. 550 F.3d 106 (2008). In reversing the panel decision and affirming the district court, the *en banc* court held that one could not "make" a statement for purposes of Rule 10b-5 by merely using a false statement created entirely by others. 597 F.3d at 442-44. The court also held that the SEC's argument would blur the line between primary and secondary liability, and the SEC's effort to impute statements to persons who had no role in their creation, composition or preparation failed both the "substantial participation" test and the "bright-line" attribution test. *Id*. at 444-48.

C. Conclusion

As discussed above, the scope of primary liability under Section 10(b) is still in flux. Among the salient questions are:

- May Section 10(b) primary liability be imposed on corporate insiders who participated in drafting, editing or reviewing corporate disclosures where no alleged misstatement is directly attributable to them, an issue that the Second Circuit left unresolved in the *PIMCO* decision? Does the answer turn on whether investors would assume that the insider was significantly involved in preparing the financial statements, such as a CFO or V.P. Sales, and therefore would have implicitly relied upon them in making an investment decision? Would the result in *Pugh* have been different if Sito had been a high level executive at the Tribune Company rather than an executive of a subsidiary, or if Sito's principal objective was to defraud investors rather than advertisers?
- When, if ever, may entities or individuals outside the corporation have primary liability based on the corporation's disclosures? Shall the test be the direct attribution test of the Second Circuit or the Fourth Circuit's case-by-case analysis of whether interested investors would attribute to the defendant a substantial role in preparing or approving the allegedly false statement? If the latter, may the nexus between the outsider and the company be more remote than the relationship between an investment advisor and the funds that the advisor effectively dominates?

V. CORPORATE SCIENTER

Plaintiffs bringing claims for securities fraud are required to allege facts that give rise to a strong inference that defendants acted with scienter. In other words, the complaint must give rise to an inference that defendants knew, or were reckless in not knowing, that their statements were false when made. The Supreme Court, in *Tellabs Inc. v. Makor Issues & Rights Ltd.,* 551 U.S. 308 (2007), held that such an inference must be at least as compelling as any competing non-culpable inference. The scienter requirement creates doctrinal challenges when applied to corporations. Because a corporation acts through its agents, it is unclear whether a strong inference of scienter by the corporation itself may be alleged without successfully alleging scienter as to an individual corporate agent.[55]

The Circuit Courts of Appeal are divided on this issue. The Second, Fourth, Sixth, Seventh, and Ninth Circuits have held that such corporate scienter allegations are permissible. The Fifth Circuit has expressly held that such pleading is inadequate. The Eighth Circuit has implicitly adopted the Fifth Circuit's view. However, both the Fifth and Eighth Circuits adopted their views prior to *Tellabs*, which mandated a holistic consideration of the complaint. Thus, it is unclear whether the Fifth and Eighth Circuits would reach the same conclusions if presented with the issue today. The First, Third, Tenth, and Eleventh Circuits have not ruled on this issue; however, related precedent and district court cases suggest that the First and Tenth Circuits would support corporate scienter while the Third and Eleventh would not.

A. Securities Fraud and Scienter

Section 10(b) makes it unlawful to use "any manipulative or deceptive device or contrivance in contravention of such rules and regulations" prescribed by the Securities and Exchange Commission ("SEC"). The Exchange Act defines a "person" as a "natural person" or a "company." Section 3(a)(9). Thus on its face, Section 10(b) creates direct liability against a corporation. *Cf. Musick, Peeler & Garrett v. Emps. Ins. of Wausau*, 508 U.S. 286, 296 (1993) (stating that Section 10(b) creates direct liability rather than derivative liability, but only for those acting with scienter). Acting under the authority granted to it by Section 10(b), the SEC promulgated Rule 10b-5, which makes it unlawful for any person to "employ any device, scheme, or artifice to defraud" in connection with the "purchase or sale of any security." 17 C.F.R. § 240.10b-5.[1] The Supreme Court has held that "[t]he scope of Rule 10b-5 is coextensive with the coverage of § 10(b)." *SEC v. Zandford*, 535 U.S. 813, 816 n.1 (2002). (citation omitted).

The Supreme Court requires a claim for securities fraud to provide proof of scienter – an "intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Until 1995, the pleading requirements with regards to scienter were governed by Rule 9(b) of the Federal Rules of Civil Procedure, which

55. As used in this article, "corporate agent" refers to any individual whose actions or knowledge can be imputed to the corporation, such as senior officers.

provided that "[m]alice, intent, knowledge, and other conditions of a person's mind may be alleged generally." In 1995, Congress established heightened pleading standards for securities fraud claims. Under the Private Securities Litigation Reform Act of 1995, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

However, because the PSLRA did not define "strong inference," lower courts applied varying interpretations in the years that followed. For example, the Second Circuit has continued to treat allegations of "motive and opportunity" as sufficient to plead scienter. *See ECA & Local 134 IBEW Joint Pension Trust of Chi. V. JP Morgan Chase Co.,* 553 F.3d 187, 198-99 (2d Cir. 2009). The Third Circuit rejected its prior acceptance of "motive and opportunity" allegations as a sole basis for alleging scienter, and instead will examine all the allegations in a complaint to decide whether they collectively will establish an inference of scienter. *Institutional Investor Gr. v. Avaya, Inc.,* 564 F.3d 242, 276 (3rd 2009). The Sixth Circuit held that "plaintiffs may plead scienter in § 10b or Rule 10b-5 cases by alleging facts giving rise to a strong inference of recklessness," but not by alleging facts merely establishing that a defendant had the motive and opportunity to commit securities fraud. *In re Comshare Inc. Sec. Lit.*, 183 F.3d 542, 549 (6th Cir. 1999). The Ninth Circuit went a step further, holding that a strong inference required facts that came "closer to demonstrating intent, as opposed to mere motive and opportunity." *In re Silicon Graphics, Inc. Sec. Lit.* 183 F.3d 970, 974 (9th Cir. 1999). The Second Circuit held that a strong inference

> may arise where the complaint sufficiently alleges that the defendants: (1) benefitted in a concrete and personal way from the purported fraud; (2) engaged in deliberately illegal behavior; (3) knew facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information they had a duty to monitor.

Novak v. Kasaks, 216 F.3d 300, 311 (2nd Cir. 2000) (citations omitted).

The issue came to the Supreme Court after the Seventh Circuit held that a complaint would survive if it "alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Makor Issues & Rights, Ltd. v. Tellabs, Inc.,* 437 F.3d 588, 602 (7th Cir. 2006). On appeal, the Supreme Court reversed, holding 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." *Tellabs, Inc., v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 309 (2007). Further, the complaint must be considered in its entirety to determine whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter. Allegations are not to be analyzed in isolation.

B. Corporate Scienter

1. Courts Adopting Corporate Scienter

In a pre-*Tellabs* decision, the Sixth Circuit implicitly adopted corporate scienter. In *City of Monroe Employees v. Bridgestone*, 399 F.3d 651, 690-91 (6th Cir. 2005), the court found that the complaint adequately pleaded scienter against the corporate defendants but not against the individual defendants. *Bridgestone* concerned a securities fraud claim against Bridgestone, Firestone (Bridgestone's wholly owned subsidiary), Bridgestone's former Chairman and CEO, and Firestone's former CEO. The complaint alleged that Bridgestone's and Firestone's annual reports and press releases contained false and misleading statements regarding the companies' knowledge of and exposure to liability arising from the sale of defective tires. The court found three representations to be actionable: (1) a Firestone press release in which it stated that "the objective data clearly reinforce our belief that these are high-quality, safe tires," (2) statements in a Bridgestone annual report indicating that no impairment of corporate assets was substantially certain to occur through problems arising from customers or regulators' actions, and (3) statements that there were no actual, material losses connected to the lawsuits and responses to the regulatory scrutiny of the defective tires. In its scienter analysis, the court found that the divergence between internal reports and external statements, the proximity in time of positive statements and contradictory revelations, opaque accounting methods, and the existence of numerous confidential settlements of private suits alleging tire defects gave rise to a strong inference of at least recklessness on the part of Firestone and Bridgestone. Accordingly, the court permitted the claims against the corporations to proceed.

In contrast, with regard to Firestone's former CEO, the court found the scienter allegations to be insufficient. The court stated:

> The Complaint pleads, regarding [Firestone's former CEO], little more than his corporate titles, dates of employment and resignation, and attendance at the quarterly meetings. [Plaintiff] does not allege by direct allegation or even upon information and belief that Ono played any role in drafting, reviewing, or approving the Firestone's "objective data" representation or the Bridgestone annual reports, 1999 or any other years.

Id. at 960. Based on the failure to plead scienter, the court upheld the dismissal of claims against Firestone's CEO. (The court dismissed the claims against Bridgestone's former chairman and CEO for lack of personal jurisdiction).[56]

Likewise, after remand in *Tellabs*, the Seventh Circuit stated that "it is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud." *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 710 (7th Cir. 2008) (*Tellabs II*). Although this language clearly accepts corporate scienter as a viable option, the court's analysis actually referred to it conclusion that Tellabs' CEO must have known that his statements were false. Further, the court was careful to note that determining ultimate liability under Section 10(b) requires

> look[ing] to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment.

(citing Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004)).

Similarly, the Second Circuit in *Teamsters Local 445 Freight v Dynex Capital*, 531 F.3d 190, 192 (2d Cir. 2008), held that "there are circumstances in which a plaintiff may plead the requisite scienter against a corporate defendant without successfully pleading scienter against a specifically named individual defendant . . . ." *Dynex* concerned allegations that Dynex, it's wholly owned subsidiary Merit, Dynex's President, and Merit's CEO violated Section 10(b) by misrepresenting the

56. A district court in the Sixth Circuit found scienter allegations against a corporate defendant sufficient, even though several of the challenged statements were not attributed directly to an individual defendant. *In re America Serv. Gr., Inc.*, No. 06-0323, 2009 WL 1348163 (M.D. Tenn. March 31, 2009).

default rates on certain asset-backed securities. The district court dismissed the complaint as to Dynex's President and Merit's CEO for failure to plead scienter, finding that the complaint did not allege that these individuals had seen or had access to specific reports or statements that indicated wrongdoing, or that they directly supervised or knew of any identified individuals engaged in specific wrongdoing. As to Dynex and Merit, however, the district court found scienter adequately pleaded because the complaint alleged that Dynex and Merit systematically originated defective loans despite clear signs that borrowers were not creditworthy.

On appeal, Dynex and Merit argued that because the complaint did not raise a strong inference of scienter as to the individual defendants, as a matter of law it could not raise a strong inference of scienter as to the corporate defendants. Rejecting that argument, the court found that "In most cases, the most straightforward way to raise such an inference for a corporate defendant will be to plead it for an individual defendant . . . it is possible to raise the required inference with regard to a corporate defendant without doing so with regard to a specific individual defendant." *Id.* at 195. The court, however, found that the specific allegations were insufficient because they did not indicate that data had been collected into reports that identified faulty loan origination practices as the reason for default. On remand, plaintiffs filed an amended complaint that included allegations from confidential witnesses that the companies routinely ignored internal underwriting policies and allegations that the individual defendants received specific reports documenting the problems with loan originations. *In re Dynex Capital, Inc. Sec. Lit.*, 2009 WL 3380621 (S.D.N.Y. Oct. 19, 2009). The district court found these allegations sufficient to plead scienter as to both the individual and corporate defendants.

In *Glazer Capital Management, LP v. Magistrim*, 549 F.3d 736, 743-45 (9th Cir. 2008), the Ninth Circuit stated that "in certain circumstances, some form of collective scienter pleading might be appropriate. For instance, . . . there could be circumstances in which a company's public statements were so important and so dramatically false that they would create a strong inference that at least *some* corporate officials knew of the falsity upon publication." (emphasis in original). However, the court concluded that "given the limited nature and unique context of the alleged misstatements in this case, we hold that the PSLRA requires Glazer to plead scienter with respect to those individuals who actually made the false statements in the merger agreement." *Id*. at 744-45.

The Fourth Circuit also has stated that "[a] complaint that alleges facts giving rise to a strong inference that at least one corporate agent acted with the required state of mind satisfies the PSLRA even if the complaint does not name the corporate agent as an individual defendant or otherwise identify the agent." *Matrix Capital Mgmt. Fund, LP v. BearingPoint*, 576 F.3d 172, 189 (4th Cir. 2009). The court found however, that the specific allegations in the complaint were insufficient and remanded with instructions to grant plaintiffs leave to file an amended complaint.

2. Courts Rejecting Corporate Scienter

The Fifth Circuit has declined to accept corporate scienter pleading. In *Southland*, cited by the Seventh Circuit in *Tellabs*, *supra*, the court held that scienter allegations must be tied to a specific agent, even when the claims are brought against the corporate defendant. The court stated that statements made by a corporate defendant with no stated author are actionable only if linked to a corporate agent with a culpable statement of mind. Statements attributed to specific corporate agents will only be actionable against the corporate defendant if the agent is shown to have a culpable state of mind. Since *Southland* predates *Tellabs*, it is unclear how the Fifth Circuit would rule if presented with the issue today. A district court in the Fifth Circuit, however, upheld the *Southland* standard in a post-*Tellabs* decision. *See In re Enron Corp. Sec. Deriv. & ERISA Lit.*, 610 F. Supp. 2d 600, 638 (S.D. Tex. 2009).

The Eighth Circuit in *Horizon Asset Management, Inc., v. H&R Block, Inc.,* 580 F.3d 755, 767 (8th Cir. 2009), acknowledged that "The appropriate standard for considering the pleading of corporate scienter under the PSLRA appears to be an open question in this circuit." Although the court did not explicitly define the standard, it implicitly rejected corporate scienter by concluding that because scienter had not been adequately pleaded with regard to any of the employees named in the complaint, scienter was not adequately pleaded as to the corporation. The court's approach echoed its holding in a pre-*Tellabs* decision where it dismissed the scienter allegations against the corporate defendant without discussion after it found the scienter allegations against the individual defendants inadequate. *Kushner v. Beverly Enters., Inc.*, 317 F.3d 820 (8th Cir. 2003).

3. Courts Undecided on Corporate Scienter

The First Circuit has not explicitly addressed the issue of corporate scienter but the analysis in its recent cases suggests it supports the theory. In *New Jersey Carpenters Pension v. Biogen IDEC, Inc.*, 537 F.3d 35 (1st Cir. 2008) and in *Miss. Pub. Employees' Retirement Sys. v. Boston Scientific Corp.*, 523 F.3d 75, 90-91 (1st Cir. 2008), the court's analysis of the scienter allegations made no distinction between the individual and corporate defendants. Tellingly, in *Boston Scientific*, where the complaint was deemed adequate, the court did not identify which individual defendant was alleged to possess the requisite the scienter. However, in *Isham v. Pernini Corp.*, 665 F. Supp. 2d 28, 36 (D.Mass. 2009), the district court recognized that the issue was undecided in the First Circuit: "Although several circuit courts of appeals have noted that it might be possible to draw a strong inference of *corporate* scienter without identifying the specific individuals who committed the fraud, no such inference can be drawn here." *Id.* at 37 (citing Tellabs, 513 F.3d at 710 and Dynex, 531 F.3d at 195-96).

The Tenth Circuit, pre-*Tellabs*, stated that "Identifying the individual sources of statements is unnecessary when the fraud allegations arise from misstatements or omissions in group-published documents such as annual reports, which presumably involve collective actions of corporate directors or officers." *Schwartz v. Celestial Seasonings, Inc.*, 124 F.3d 1246, 1254 (10th Cir.1997).[57] Recent district court cases in the Tenth Circuit

57. The Tenth Circuit's statement in *Celestial Seasonings* reflects the group pleading doctrine, a judicial presumption that statements in group-published documents including annual reports and press releases are attributable to officers and directors who have day-to-day control or involvement in regular company operations. *See Winer Family Trust v. Queen*, 503 F.3d 319, 335 (3d Cir.2007). Under the doctrine, where defendants are insiders with such control or involvement, their specific connection to fraudulent statements in group-published documents is unnecessary. The Supreme Court in *Tellabs* recognized that there was debate over whether the group pleading doctrine survived the PSLRA, but

establish the continuing viability of this approach within the circuit. *See In re SemGroup Energy Partners, L.P.*, No. O8-MD-1989 (GFK) (FHM), 2010 WL 1816434, at *13 (N.D. Okla. April 30, 2010) (collecting cases). The Tenth Circuit has also stated that the scienter of senior controlling officers of a company may be attributed to the company itself to establish corporate liablity. *Adams v. Kinder Morgan*, 340 F.3d 1086, 1106 (10th Cir. 2003). As such, it seems likely that the Tenth Circuit would permit allegations of corporate scienter to satisfy the PSLRA's heightened pleading requirements.

In contrast, although the Third Circuit has not addressed the issue, district courts in that Circuit have expressed doubts as to whether such a rule would be adopted in light of the rejection of the group pleading theory. *See City of Roseville Employees' Ret. Sys. v. Horizon Lines, Inc.*, No. 08-969, 2010 WL 1994693, at *19 -20 (D. Del. May 18, 2010) ("Our Court of Appeals has not ruled on the validity of the "collective scienter" theory within the Third Circuit"); *Zavolta v. Lord, Abbett & Co. LLC,* No. 08-cv-04546, 2010 WL 686546, at *7-8 (D.N.J. Feb.24, 2010); *In re Bio-Technology Gen Corp.,* 2006 WL 3068553, at *13-14 (D.N.J. Oct. 26, 2006).

Recently, the Eleventh Circuit stated that "Although the Second Amended Complaint failed to adequately plead scienter for any of the individual defendants, theoretically, the Second Amended Complaint could create a strong inference that the corporate defendant, RelationServe, acted with the requisite state of mind." *Thompson v. RelationServe Media, Inc.*, 610 F.3d 628, 635 (11th Cir. 2010). The court found, however, that the complaint failed to "sufficiently plead scienter as to any of the individuals who served as corporate directors or officers of RelationServe, and there are no other allegations that give rise to an inference of scienter." *Id*. The court's analysis does not clearly indicate whether scienter could be established as to a corporate defendant without identifying which individual scienter. A district court in the Circuit held that because scienter had not been adequately pleaded as to the individual defendants, and because the

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declined to address the issue since it was not properly before the Court. Because *Celestial Seasonings* was issued post-PSLRA, the doctrine remains viable in the Tenth Circuit. In contrast, the Fifth, Seventh and Third Circuits have rejected the doctrine.

corporation's state of mind is the state of mind of its officials, scienter was not adequately pleaded as to the corporation. *Waterford Tp. Gen. Emps. Ret. Sys. v. CompuCredit Corp.*, 2009 WL 4730315, at * 8 (N.D. Ga. Dec. 4, 2009). Thus it appears the issue is open in the Eleventh Circuit, but that courts are likely to find a complaint inadequate unless an individual possessing the requisite scienter is identified.

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