SIMPSON THACHER

SECURITIES LAW ALERT

NOVEMBER 2010

This month's edition of the Securities Law Alert addresses the Fifth Circuit's adoption of the bright-line attribution rule for secondary actor liability under Section 10(b), and the SEC's new proposed rules for the Dodd-Frank Act whistleblower program. This edition also discusses four decisions from the Southern District of New York: one denying a dismissal motion in the SEC's enforcement action against Goldman, Sachs banker Fabrice Tourre but requiring the SEC to replead; another denying in part and granting in part a motion to dismiss the Citigroup subprime action; a third addressing the question of what constitutes a cognizable loss for the purposes of a Section 11 claim involving mortgage-backed securities; and finally, a fourth dismissing the complaint (without prejudice) in the Freddie Mac subprime action.

The Fifth Circuit Adopts the Bright-Line Attribution Rule for Secondary Actor Liability Under Section 10(b)

Last month, we discussed the circuit split on the question of whether secondary actors can be held liable under Section 10(b) for statements that are not explicitly attributed to them. (Please click here to read the complete article.) The Fourth Circuit has held that "the attribution determination is properly 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." *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 124 (4th Cir. 2009) ("*Janus I*"). The Second Circuit, on the other hand, has adopted a bright-line attribution rule under which "secondary actors can be liable in a private action under Rule 10b-5 for only those statements that are explicitly attributed to them." *Pac. Inv. Mgmt. Co. v. Mayer Brown LLP*, 603 F.3d 144, 155 (2d Cir. 2010). In the Second Circuit's view, "[t]he mere identification of a secondary actor as being involved in a transaction, or the public's understanding that a secondary actor 'is at work behind the scenes' are alone insufficient." *Id.* (citations omitted). The Supreme Court is expected to provide guidance on this issue in the pending case of *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525 (U.S. petition for cert. filed Oct. 30, 2009) ("*Janus II*").

In *Affco Investments 2001 LLC v. Proskauer Rose, L.L.P.*, No 09-20734, 2010 WL 4226685 (5th Cir. Oct. 27, 2010), the Fifth Circuit cast its vote in favor of the bright-line attribution rule. The plaintiffs in *Affco* had invested in a tax avoidance structure marketed by KPMG. To assure the plaintiffs of the legality of the transactions, KPMG had "promised to provide independent opinions from 'several major national law firms' that had analyzed and approved the tax strategy." *Id.* at *1. According to the complaint, "the law firm of Proskauer Rose … worked with KPMG and other defendants behind the scenes to prepare,

This edition of the Securities Law Alert was edited by Peter E. Kazanoff (pkazanoff@stblaw.com/212-455-3525) and Jonathan K. Youngwood (jyoungwood@stblaw.com/212-455-3539).

in advance, model opinions supporting the validity of the tax scheme." *Id.* However, the plaintiffs did not claim that "they had knowledge of Proskauer's role prior to their actual investment in the tax scheme." *Id.* at *9. There were no allegations that the plaintiffs "ever saw or heard any Proskauer work product before making their decision" or that "the promoters specifically identified Proskauer as one of the 'major national law firms' that had vetted and cleared the tax scheme[.]" *Id.*

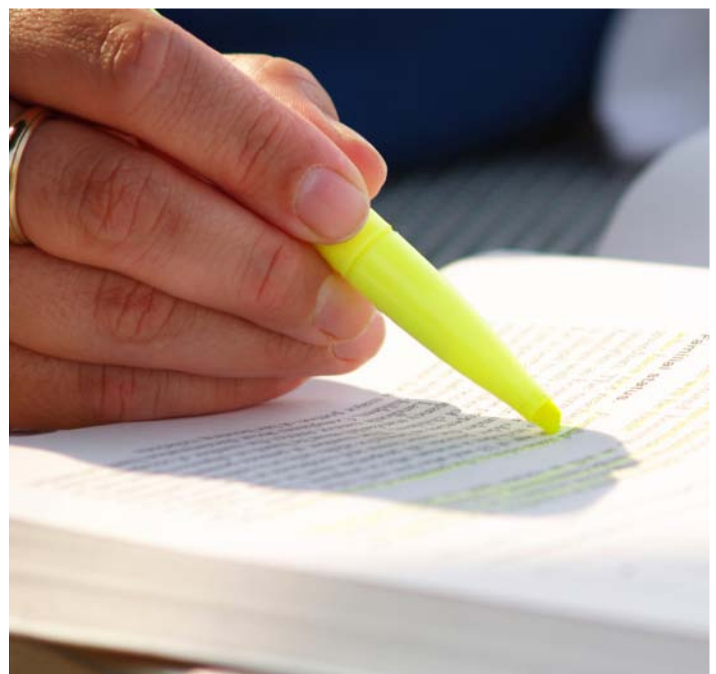
Given the "behind the scenes" nature of Proskauer's work, the Fifth Circuit held that the district court had properly dismissed the plaintiffs' Section 10(b) claims for failure to show reliance. The Fifth Circuit explained that "[w]ithout *direct attribution* to Proskauer of its role in the tax scheme, reliance on Proskauer's participation in the scheme is too indirect for liability." *Id.* at *6 (emphasis added). Concurring with the Second Circuit's analysis in *PIMCO*, the *Affco* court held that "explicit attribution is required to show reliance under section 10(b)." *Id.* at *7.

The Fifth Circuit looked to the Supreme Court's reasoning in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) in reaching this conclusion. Although "[t]he Supreme Court has not directly addressed the question … [of] whether a secondary actor can be held liable in a private section 10(b) action for deceptive conduct not attributed to it before an investor decides to invest," the *Affco* court found that *Stoneridge* "appears to imply that a secondary actor's conduct or statement must be known to the investor in order for the investor to rely upon it." *Affco*, 2010 WL 4226685, at *6 – *7.

Practical considerations also factored into the Fifth Circuit's decision. The *Affco* court explained that "[k]nowing the identity of the speaker is essential to show reliance because a word of assurance is only as good as its giver." *Id.* at *8. "Specific attribution to a reputable source also induces reliance because of the ability to hold such a party responsible should things go awry." *Id.* Moreover, imposing an attribution requirement "makes clear the boundary between primary violators—who are open to liability in private securities actions—and aiders and abettors, to whom the private right of action under section 10(b) does not extend." *Id.* at *9.

While the Fifth Circuit's decision squarely supports the bright-line attribution rule for secondary actor liability, it merits mention that the facts in *Affco* differ in one important respect from the facts in *Janus II*—the case currently before the Supreme Court. In *Affco*, the plaintiffs did not know of "Proskauer's role in the tax scheme during the relevant time period when they were making their investment decisions." *Affco*, 2010 WL 4226685, at *9. In the *Janus* litigation, on the other hand, the Fourth Circuit found that an investment advisor to a family of mutual funds could be held liable for misstatements in mutual fund prospectuses that were not attributed to the investment advisor because "interested investors would infer that [the investment advisor] played a role in preparing or approving the content of the [mutual] fund prospectuses." *Janus I*, 566 F.3d at 127.

We will continue to follow case law developments on the question of whether attribution is required for secondary actor liability under Section 10(b) and update you in future editions of the Securities Law Alert.



The SEC Invites Comments on the New Proposed Whistleblower Program Rules

The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in July 2010, amended the Securities Exchange Act of 1934 to provide incentives and protection for whistleblowers who report securities fraud violations to the SEC. Pub. L. No. 111-203, 2010 U.S.C.C.A.N. (124 Stat. 1376). Under the new Section 21F of the Exchange Act, the SEC shall award whistleblowers between ten to thirty percent of the monetary sanctions imposed in actions resulting in penalties of more than a million dollars. The financial incentive is limited to whistleblowers who "voluntarily" provide "original information" to the SEC that "leads to the successful enforcement" of a "covered judicial or administrative action, or related action." Exchange Act, Section 21F(b)(1). To protect whistleblowers from employer retaliation, Section 21F prohibits companies from discharging, demoting or taking other adverse actions against individuals who report securities fraud to the SEC. *See* Section 21F(h).

On November 3, 2010, the SEC issued detailed proposed rules for implementing the Dodd-Frank Act's whistleblower program. The SEC has invited the public to submit comments on these proposed rules by December 17th, 2010. Highlights of the proposed rules follow.

Who Qualifies as a "Whistleblower"?

Proposed Rule 21F-2(a) defines a whistleblower as "an individual who, alone or jointly with others, provides information to the [SEC] relating to a *potential* violation of the securities laws." Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, 17 CFR pts. 240 and 249 at 6 (proposed Nov. 3, 2010) ("Proposed Rules") (emphasis added).

The SEC has explained the need to expand the Dodd-Frank Act definition to include reporters of *potential* violations because only individuals who qualify as "whistleblowers" are eligible for Section 21F's confidentiality and anti-retaliation protections. Under the expanded definition of "whistleblower," the SEC does not have to determine at the outset whether an actual violation occurred in order for an individual to qualify for these protections. Moreover, even if the information provided to the SEC ultimately does not result in a proven violation of the securities laws, the reporting individual remains protected from adverse employer consequences.

Who Is Ineligible for a Whistleblower Award?

Section 21F(c)(2), as originally enacted by the Dodd-Frank Act, provides that certain individuals are not eligible for whistleblower awards. These individuals include: specified government and quasi-government officials, including employees of the Department of Justice, self-regulatory organizations, and the Public Company Accounting Board; whistleblowers who are convicted of a criminal violation in connection with the information provided; and individuals who obtain information in the course of undertaking a financial audit.

Proposed Rule 21F-4(b)(4) expands the list of individuals who are ineligible for whistleblower awards. Individuals who will not be considered to have provided "independent knowledge" or "independent analysis" of a potential violation to the SEC include:

- People who have a pre-existing legal or contractual duty to report their information.
- Attorneys who attempt to use information obtained from client engagements to make whistleblower claims for themselves (unless disclosure of the information is permitted under SEC rules or state bar rules).
- Independent public accountants who obtain information through an engagement required under the securities laws.

- Foreign government officials.
- People who learn about violations through a company's internal compliance program or who are in positions of responsibility for an entity, and the information is reported to them with the expectation that they will take appropriate steps to respond to the violation.

Press Release, Securities and Exchange Commission, SEC Proposes New Whistleblower Program Under Dodd-Frank Act (Nov. 3, 2010) ("SEC Press Release"), *available at http://sec.gov/news/press/2010/2010-213.htm*. These exclusions were designed to ensure that companies would continue to share information regarding potential violations openly with counsel, accountants and internal compliance officers.

The exclusion for individuals who learn about potential violations through a company's internal compliance program is specifically "intended to prevent company personnel from 'front running' legitimate internal investigations" by reporting the information to the SEC before the company has had a chance to investigate the conduct at issue. *Id.* This exclusion is limited, however. If "the company does not disclose the information to the [SEC] within a reasonable time or acts in bad faith," these individuals can qualify as whistleblowers under Section 21F. *Id.* The SEC has cautioned that what constitutes a "reasonable time" will "necessarily be a flexible concept that will depend on all of the facts and circumstances of the particular case." Proposed Rules, 17 CFR at 26.

Under What Circumstances Is Information Considered to Have Been Provided "Voluntarily"?

Proposed Rule 21F-4(a)(1) considers a whistle-blower's submission of information "voluntary" if the individual "provide[s] information before the government, a self-regulatory organization or the Public Company Accounting Oversight Board asks for it." SEC Press Release.

What Constitutes "Original Information"?

Proposed Rule 21F-4(b) defines the term "original information" to mean information that is "based upon the whistleblower's independent knowledge or independent analysis, not already known to the Commission and not derived exclusively from certain public sources." *Id.* Information derived from publicly available sources, such as corporate press releases, media reports, court filings and documents obtained through Freedom of Information Act requests does not constitute "original information" for purposes of Section 21F. *See* Proposed Rules, 17 CFR at 18.

The proposed rules do not "require that a whistle-blower have direct, first-hand knowledge of potential violations." *Id.* The whistleblower's "knowledge may be obtained from any of the whistleblower's experiences, observations, or communications[,]" including "facts or other information that has been conveyed to the whistleblower by third parties." *Id.*

Notably, under Proposed Rule 21F-4(b)(3), academic or professional studies can qualify as "original information." *See id.* at 19. The SEC has explained that "[t]his definition recognizes that there are circumstances where individuals can review publicly available information, and, through their additional evaluation and analysis, provide vital assistance to the Commission staff in understanding complex schemes and identifying securities violations." *Id.*

When Is A Whistleblower's Information Deemed to Lead to the Successful Enforcement by the SEC of a Judicial or Administrative Action?

Under proposed Rule 21F-4(c), a whistleblower's information is deemed to have led to the "successful enforcement" of a judicial or administrative action if: (1) "the information results in a new examination or investigation being opened and significantly contributes to the success of a resulting enforcement action," or (2) "the conduct was already under investigation when the information was submitted, but the information is essential to the success of the action and would not otherwise have been obtained." SEC Press Release.

Are There Penalties for the Provision of False Information?

Proposed Rule 21F-9 requires a whistleblower to certify, under penalties of perjury, that "all information contained in the whistleblower's submission [ ] is true, correct, and complete to the best of the whistleblower's knowledge, information and belief." Proposed Rules, 17 CFR at 63.

Where the information is provided by an anonymous whistleblower, Proposed Rule 21F-9 requires an attorney representing the whistleblower to certify that he or she has verified the whistleblower's identity and reviewed the whistleblower's statement for completeness and accuracy. *See id.* at 65. An attorney may be subject to disciplinary sanctions under Rule 102(e) for misconduct before the SEC in connection with whistleblower representations.

Will the Whistleblower Program Undermine Internal Compliance Programs?

The SEC has attempted to "include provisions to discourage employees from bypassing their own company's internal compliance programs." SEC Press Release. Under Proposed Rule 21F-4(b)(7), whistleblowers are "clocked in" under the SEC program on the date that they report a potential violation to the company's internal compliance personnel. Proposed Rules, 17 CFR at 32-33. Whistleblowers then have 90 days to provide the same information to the SEC. *Id.*

While whistleblowers who first utilize internal compliance programs are protected, the proposed rules do not *require* whistleblowers to use internal channels before reporting information to the SEC. The SEC has justified this approach by explaining that "while many employers have compliance programs that are well-documented, thorough, and robust, and offer whistleblowers appropriate assurances of confidentiality, others lack such established procedures and protections." *Id.* at 34. The SEC has signalled its intent to cooperate with companies in the course of investigating whistleblower allegations, stating that "in appropriate cases" the SEC will "contact a company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back." *Id.* However, the Proposed Rules set forth no procedures for the SEC to "refer" such matters to companies.

The Proposed Rules do provide whistleblowers with some incentives to utilize internal compliance programs first. Under Proposed Rule 21F-6, one of the criteria the SEC can use in determining the exact percentage of the award is "whether, and the extent to which, a whistleblower reported the potential violation through effective internal whistleblower, legal or compliance procedures before reporting the violation to the [SEC]." *Id.* at 51. Reporting potential violations through internal compliance mechanisms first is "not a requirement for an award above the 10 percent statutory minimum and whistleblowers will not be penalized if they do not avail themselves of this opportunity for fear of retaliation or other legitimate reasons." *Id.*

Surprisingly, Proposed Rule 21F-4(1)(1) permits individuals to qualify for awards under the whistleblower program if they report "original" information *after* being questioned by the company in the course of an investigation but *before* the company

self-reports the potential violation to the SEC. *See id.* at 12 n. 11. The SEC's rationale for this rule is that "there is no assurance that an employer will ultimately disclose to the [SEC] potential violations uncovered in the course of an internal investigation or similar process…" *Id.* If employees bring potential violations to the SEC's attention before a company has had the chance to complete its internal investigation, the company may lose the opportunity to present its case to the SEC first, and may also miss out on valuable self-reporting credits available under existing SEC and Department of Justice policies.

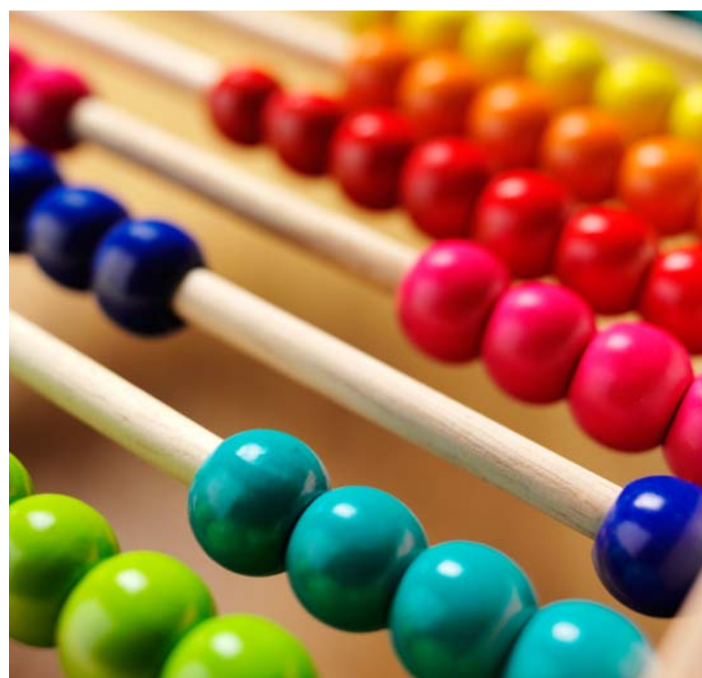
The SEC's Proposed Rules have already generated significant public commentary, particularly with respect to the interaction between the whistleblower reporting provisions and internal compliance programs. Many have raised concerns that the new rules incentivize whistleblowers to bypass internal compliance procedures entirely in a race to the SEC.

The Southern District of New York Denies Goldman, Sachs Executive's Dismissal Motion in the SEC's Fraud Action But Makes the SEC Replead

In April 2010, the SEC brought suit against Goldman, Sachs & Co. and Goldman, Sachs executive Fabrice Tourre in connection with Abacus 2007-AC1, a synthetic collateralized debt obligation linked to the performance of residential mortgage-backed securities. The SEC claimed that Goldman, Sachs and Tourre intentionally created a structure that was designed to fail. According to the complaint, the Abacus marketing materials did not disclose that Paulson & Co., Inc., a large hedge fund with "economic interests directly adverse to [Abacus] investors… played a significant role in the portfolio selection process." Complaint at ¶2. Two European financial institutions—IKB Deutsche Industriebank AG and ABN Amro—ultimately lost nearly a billion dollars in connection with their investments in Abacus. Goldman, Sachs settled the headline-making SEC enforcement action for $550 million. However, Tourre continues to battle the SEC in an effort to clear his reputation.

Following the Court's ruling in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), Tourre moved for judgment on the pleadings on the grounds that the Abacus transaction occurred outside of the United States and therefore could not give rise to Section 10(b) liability. The SEC responded by arguing that the transaction did in fact take place in the United States because Goldman, Sachs and Tourre structured and marketed Abacus in New York. According to the SEC, the Abacus offering materials confirm the domestic nature of the transaction:

> [T]he ABACUS 2007-AC1 offering memorandum unambiguously states that the offered notes would be delivered "only in New York, New York," that the securities were being offered by [Goldman, Sachs] "in the United States," that [Goldman, Sachs], a New York registered broker-dealer, was "selling" and "offering" the notes, and that the notes were being offered in denominations of U.S. dollars.



SEC's Memorandum of Law in Opposition to Defendant Tourre's Motion for Judgment on the Pleadings ("SEC Brief in Opposition"), at 12.

In a footnote, the SEC cited the Dodd-Frank Act, which, according to the SEC, "effectively overruled *Morrison* by codifying the Second Circuit's long-standing conduct and effects test … for civil enforcement actions brought by the SEC." *Id.* at 7 n.1. The Dodd-Frank Act provides that federal courts have jurisdiction to hear SEC antifraud actions involving "(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs *outside the United States* and involves *only foreign investors*; or (2) conduct occurring *outside the United States* that has a foreseeable substantial effect within the United States." Pub. L. No. 111-203, § 929P, 124 Stat. 1376 (codified as amended at 15 U.S.C. § 78aa) (emphasis added). (Please click here to read our discussion of the Dodd-Frank Act's impact on SEC antifraud actions in the September edition of the Securities Law Alert.) Finally, the SEC requested the opportunity to amend its complaint to provide additional detail as to the domestic conduct involved in the Abacus transaction. *See* SEC Brief in Opposition at 3.

On November 1st, the Southern District of New York denied Tourre's motion for judgment on the pleadings and granted the SEC's request for leave to file an amended complaint on the grounds that the complaint was filed prior to the Court's decision in *Morrison*. The case is among the first to address the extraterritorial reach of post-*Morrison* SEC enforcement actions.

The Southern District of New York Narrows the Collateralized Debt Obligation-Related Allegations in the Citigroup Subprime Class Action

In a fact-specific decision dated November 9th, 2010, the Southern District of New York substantially trimmed the allegations in dispute in the subprime-related class action brought against Citigroup, Inc. and a number of its current and former executives, officers and directors. *In re Citigroup Inc. Sec. Litig.*, Nos. 09 md 2070 (SHS), 07 Civ. 9901 (SHS), 07 Civ. 10258 (SHS), 08 Civ. 135 (SHS), 08 Civ. 136 (SHS), 2010 WL 4484650 (S.D.N.Y. Nov. 9, 2010).

The plaintiffs' "principal grievance" with respect to Citigroup's collateralized debt obligations ("CDOs") is that the company "did not disclose that it held tens of billions of dollars of super-senior CDOs until November 4, 2007." *Id.* at *6. According to the complaint, the "market knew that Citigroup had underwritten billions of dollars of CDOs" but "did not know who had purchased the CDOs that Citigroup had underwritten." *Id.* The plaintiffs alleged that Citigroup "intentionally hid the truth: namely that billions of dollars of CDOs had not been purchased at all but had, instead, been retained by Citigroup." *Id.* In the plaintiffs' view, Citigroup did not disclose the full extent of its CDO exposure until April 2008.

The court took a scissor to the plaintiffs' hefty complaint—measuring "536 pages long, contain[ing] 1,265 paragraphs and weigh[ing] six pounds"—and limited the claims to "alleged misstatements and omissions occurring between February 2007 and April 2008 concerning Citigroup's [CDO] holdings." *Id.* The court dismissed all claims involving Citigroup's Alt-A residential mortgage-backed securities exposure; the company's involvement with structured investment vehicles; its mortgage lending business; its auction rate securities business and holdings; its leveraged loan and collateralized loan obligations business; and statements of the company's overall financial health between December 2007 and November 2008. *Id.* at *30 – *38. In addition, the court dismissed the plaintiffs' CDO-related allegations predating February 2007, and permitted the action to go forward against only seven of the individual defendants named in the complaint. *Id.* at *38.

The Court Sustained the Plaintiffs' Pre-November 4, 2007 CDO-Related Allegations

The court found that the plaintiffs had adequately stated a claim as to "three classes of actionable misstatements or omissions in Citigroup's statements" concerning the company's CDO portfolio prior to the November 4, 2007 disclosures. *Id.* at *23.

First, the plaintiffs alleged that Citigroup made "incomplete and misleading disclosures about the extent of its CDO holdings." *Id.* The plaintiffs pointed to "a set of statements that gave the impression that Citigroup had minimal, if any, exposure to CDOs when, in fact, it had more than $50 billion in exposure." *Id*. In response to the Citigroup defendants' claims that there was no duty to disclose, the court found that "disclosure of Citigroup's CDO holdings was necessary to prevent other statements—such as the boilerplate statement that the company *may* have such exposure—from being false or misleading." *Id.* at *24 (emphasis in original). As to the defendants' argument that information about the extent of Citigroup's CDO holdings was publicly available, the court determined that this "raises a factual question and thus provides no reason at this early stage to dismiss plaintiffs' claims." *Id.*

Second, the plaintiffs alleged that a number of Citigroup's "misstatements and omissions … gave the impression that Citigroup's CDO holdings were insulated from the subprime mortgage market." *Id*. The court found these statements and omissions to be misleading because "the Complaint alleges in detail that the deterioration of the subprime market put Citigroup's CDO holdings directly at risk." *Id.*

Third, the plaintiffs claimed that Citigroup "overstated the value of its CDO holdings between February 2007 and October 2007." *Id*. In support of these allegations, the plaintiffs cited declines in the ABX and TABX indices—which the plaintiffs claimed were "directly observable indicators of the value" of certain tranches of CDOs and residential mortgage-backed securities. *Id*. (internal quotations omitted). The defendants' objected to the plaintiffs' valuation methodology and "counter[ed] that the ABX and TABX indices [were] not appropriate barometers of the value of Citigroup's CDOs." *Id.* The court determined that these valuation issues "amount to factual disputes that this Court cannot resolve on a motion to dismiss." *Id.*

The Court Found that the Plaintiffs Sufficiently Alleged Scienter for CDO-Related Misstatements and Omissions from February 2007 to November 3, 2007

With respect to CDO-related misstatements and omissions predating Citigroup's November 4, 2007 disclosure, the court found that the complaint "support[s] a strong inference that, from February 2007, someone whose intent could be imputed to the corporation acted with the requisite scienter." *Id*. at *25 (internal quotations omitted). The complaint "details a number of actions Citigroup took that indicate awareness of CDO risk," including: purchasing credit default swaps to hedge the risks of super senior CDO tranches; establishing a special purpose entity to assume the risks of super senior Commercial Paper CDO tranches; and holding daily executive meetings to discuss Citigroup's CDO exposures. *Id.* at *26.

According to the plaintiffs, Citigroup was uniquely

well-positioned to understand the risks inherent in its CDO portfolio because the company underwrote the CDOs at issue. The company "knew the inputs and assumptions that went into creating these assets and thus was in the best position to recognize the threats they faced as the subprime mortgage market deteriorated." *Id.* Moreover, Citigroup's own analysts and credit strategists had begun "foreseeing an upcoming CDO meltdown" by March 2007. *Id.*

What the court found most persuasive were the allegations that "Citigroup was taking significant steps internally to address increasing risk in its CDO portfolio" while "at the same time … continuing to mislead investors about the significant risks those [CDO] assets posed." *Id.* at *27. The court determined that "[t]his incongruity between word and deed establishes a strong inference of scienter." *Id.*

The court limited its scienter findings to the period from February 2007 onward. By that point, "CDO risk was well-understood within Citi and without." *Id.* (internal quotations omitted). The court found that the plaintiffs' allegations for the period from October 2006 to February 2007 "at best could only support an inference of recklessness with respect to the risks posed by *junior* CDO tranches," which the court found inadequate to establish scienter because the complaint centers on "Citigroup's accumulation of $55 billion in *super senior* CDO tranches." *Id.* (emphasis in original). As to the period from 2004 through most of 2006, the court determined that the complaint is "devoid of any factual allegations that could give rise to an inference of scienter." *Id.*

The Court Also Upheld the Plaintiffs' CDO-Related Allegations Involving Misstatements and Omissions On and After November 4, 2007

On November 4, 2007, Citigroup "disclosed that it held $43 billion of super senior CDO tranches simultaneously with the fact of their writedown by an expected $8 – $11 billion." *Id.* at *29 (citations omitted). The plaintiffs contended that this disclosure still did not account for the full extent of Citigroup's CDO exposure, because it did not include $10.5 billion in CDOs for which the company had purchased insurance. *Id.* Moreover, the plaintiffs claimed that the disclosure "estimated inadequate writedowns on its CDOs, thereby overstating their value." *Id.* The court found these allegations sufficient to state a claim as to Citigroup's November 4, 2007 writedown and the CDO-related misstatements and omissions that followed until April 2008, when the plaintiffs alleged that Citigroup accurately valued its CDO portfolio. *Id.*

The court also concluded that the plaintiffs had "establish[ed] a strong inference that [Citigroup Chief Financial Officer Gary Crittenden] was at least reckless" with respect to statements made regarding the company's CDO exposure. *Id.* In a conference call the day after Citigroup's CDO disclosure, Crittenden "acknowledged … that Citigroup had indirect exposures to CDO losses in response to an analyst's question about CDO insurers." *Id.* Taken in context, the court found that "Crittenden was aware of the potential likelihood of insurer default or at the least was reckless in failing to recognize it." *Id.*

In addition, the court determined that the complaint "give[s] rise to a strong inference that [Crittenden] acted with scienter with respect to Citigroup's supposedly false CDO valuations." *Id.* at *30. In response to analysts' questions regarding "a discrepancy between Citigroup's [CDO] valuations and certain declines in the ABX and TABX indices," Crittenden "acknowledged his familiarity with these indices but contended that their relevance to CDO values was limited." *Id.* The court found that these statements "demonstrate scienter because, though aware of the ABX and TABX indices, [Crittenden] falsely or recklessly denied their relevance to CDO valuation." *Id.* (citations omitted). Citigroup ultimately revised its CDO valuation methodology to take account of the ABX index, a fact which the court found "supports an inference of scienter." *Id.*

While the court found that the plaintiffs had adequately pleaded scienter as to both Crittenden and Citigroup, the court determined that the complaint

failed to establish scienter with respect to any other individual defendant in connection with Citigroup's CDO-related misstatements and omissions on and after November 4, 2007.

The Court Sustained Claims against Seven Individual Citigroup Defendants

Of the fourteen individual defendants named in the complaint, the court upheld claims against only the seven defendants—including Charles Prince, Citigroup's former Chief Executive Officer, and Robert Rubin, former Chairman of Citigroup's Board of Directors—who attended meetings to discuss Citigroup's CDO exposure in the summer of 2007. The court found the "mere existence" of these meetings sufficient to establish scienter: "That defendants engaged in meetings concerning Citigroup's CDO risks is inconsistent with the company's public statements downplaying or concealing that risk." *Id.*

The court relied on the group pleading doctrine to hold these individual defendants responsible for the misleading statements and omissions at issue. Because the defendants were "involved in the preparation of Citigroup's SEC filings during the relevant time period or were otherwise deeply involved in Citigroup's day-to-day activities," the court found that the "allegations are sufficient for the claims against these defendants to proceed." *Id.* The court also concluded that the group pleading doctrine applied to former outside director Robert Rubin because he "wielded significant influence within the company" and "convened the meetings in the summer of 2007 that considered the company's CDO exposure." *Id.*

The Southern District of New York Dismisses Section 11 Claims Involving Mortgage-Backed Securities

In *NECA-IBEW Health & Welfare Fund v. Goldman, Sachs & Co.*, No. 08 Civ. 10783 (MGC), 2010 WL 4054149 (S.D.N.Y. Oct. 15, 2010) ("*NECA*"), the Southern District of New York dismissed Section 11 claims brought by the purchaser of mortgage-backed securities where there had been no interruption in monthly payments under those securities.

Goldman, Sachs & Co. sold the mortgage-backed securities at issue with an "express warning that they might not be resalable." *Id.* at *3. The disclaimer unambiguously advised investors that they "'may not be able to sell [their] certificates readily or at prices that will enable [investors] to realize [their] desired yield.'" *Id.* at *1 (quoting the Prospectus Supplement).

Notwithstanding this disclaimer, the plaintiff based its Section 11 claim on the decline in resale value of the mortgage-backed securities. The plaintiff alleged that "'the value of the Certificates has diminished greatly since their original offering, as has the price at which members of the Class can dispose of them in the secondary market[.]'" *Id.* at *3. The plaintiff further contended that "'the holders of the Certificates are [now] exposed to much more risk than the Offering Documents represented with respect to both the timing and the absolute cash flow to be received.'" *Id.* at *4 (citations omitted).

In response, the Goldman, Sachs defendants took the position that purchasers of mortgage-backed securities "only suffer loss when they do not receive the 'pass-through' cash flow payments to which they are entitled." *Id.* at *3. "[I]nsofar as [the plaintiff] does not allege a termination of monthly distributions due under the Certificates that it purchased," the

defendants argued that "[the plaintiff] has not suffered an injury cognizable under Section 11." *Id.*

The Southern District of New York ruled in favor of the defendants, holding that the plaintiff "must allege the actual failure to receive payments due under the Certificates" to show a loss under Section 11. *Id.* at *4. It was not sufficient for the plaintiff to "allege an injury based upon the hypothetical price of the Certificates on a secondary market at the time of suit." *Id.* at *3. The court also rejected the plaintiff's claims regarding "the risk of diminished cash flow in the future" on the grounds that "Section 11 does not permit recovery for increased risk." *Id.* at *4.

In reaching its decision, the *NECA* court distinguished an earlier Southern District of New York ruling in the case of *New Jersey Carpenters Health Fund v. DLJ Mortgage Capital, Inc.*, No. 08 Civ. 5653 (PAC), 2010 WL 1473288 (S.D.N.Y. March 29, 2010) ("*DLJ Mortgage*"). There, too, the plaintiff brought Section 11 claims in connection with mortgage-backed securities for which all principal and interest payments had continued as scheduled. The plaintiff cited a 79% drop in resale value as the basis for its claims. Significantly, the offering documents for the mortgage-backed securities at issue in *DLJ Mortgage* contained no disclaimer with respect to future liquidity or resale value.

The defendants in *DLJ Mortgage* argued that there was no cognizable injury under Section 11 because the plaintiff "[did] not allege that it failed to receive any principal or interest payments due under its Certificates." *Id.* at *5. The *DLJ Mortgage* court rejected the defendant's position as "too cramped a reading of damages" under Section 11. *Id.* Finding that the plaintiff "may have purchased the Certificates expecting to resell them," the court held that the plaintiff's "market value allegations [were] sufficient" to state a cognizable loss under Section 11. *Id.*

The *NECA* court determined that the ruling in *DLJ Mortgage* did not govern the case at hand, because the offering materials for the mortgage-backed securities at issue in *NECA* contained a clear warning to investors that the investments had limited resale potential. While the plaintiff in *DLJ Mortgage* might reasonably have expected to sell its mortgage-backed securities for a profit, the plaintiff in *NECA* "made an investment that it knew might not be liquid." *NECA*, 2010 WL 4054149, at *3.

The Underwriters Are Dismissed from the Freddie Mac Subprime Class Action

On October 20th, the Southern District of New York dismissed the complaint in the Freddie Mac subprime class action for the third time. The plaintiffs alleged Section 10(b) claims against the underwriters of Freddie Mac Series Z Preferred Stock, PriceWaterhouseCoopers LLP, and several former officers of Freddie Mac[1]. In the court's view, the 269-page complaint was not only "long and wordy" but also "very unspecific." Transcript of Oral Argument at 4, *Kreysar v. Syron*, No. 09 CV 832 (MGC) (S.D.N.Y. Oct. 20, 2010). The court found that the complaint provided no details as to the claimed misstatements or omissions at issue. "I cannot really tell what was misrepresented from the allegations of this complaint," Judge Miriam Cedarbaum said during oral arguments on the motion to dismiss. *Id.* at 3. "I don't think a complaint should require too much imagination." *Id.* at 12. She gave the plaintiffs until November 4, 2010 to file an amended complaint. *Id.* at 21.

Prior to filing their amended complaint in November, the plaintiffs voluntarily dismissed the two remaining underwriter defendants from the action. With this dismissal, the underwriters of Freddie Mac preferred stock are no longer named in any class action complaint related to the events surrounding Freddie Mac's conservatorship or the underwriting of Freddie Mac securities.

---

[1] Simpson Thacher represents the underwriters in the matter.

NEW YORK

Bruce D. Angiolillo
212-455-3735
bangiolillo@stblaw.com

Michael J. Chepiga
212-455-2598
mchepiga@stblaw.com

Mark G. Cunha
212-455-3475
mcunha@stblaw.com

Paul C. Curnin
212-455-2519
pcurnin@stblaw.com

Michael J. Garvey
212-455-7358
mgarvey@stblaw.com

Paul C. Gluckow
212-455-2653
pgluckow@stblaw.com

David W. Ichel
212-455-2563
dichel@stblaw.com

Peter E. Kazanoff
212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
212-455-7694
jlevine@stblaw.com

Mary Elizabeth McGarry
212-455-2574
mmcgarry@stblaw.com

Joseph M. McLaughlin
212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
212-455-2696
lneuner@stblaw.com

Barry R. Ostrager
212-455-2655
bostrager@stblaw.com

Thomas C. Rice
212-455-3040
trice@stblaw.com

Mark J. Stein
212-455-2310
mstein@stblaw.com

Alan C. Turner
212-455-2472
aturner@stblaw.com

George S. Wang
212-455-2228
gwang@stblaw.com

David J. Woll
212-455-3136
dwoll@stblaw.com

Jonathan K. Youngwood
212-455-3539
jyoungwood@stblaw.com

LOS ANGELES

Michael D. Kibler
310-407-7515
mkibler@stblaw.com

Chet A. Kronenberg
310-407-7557
ckronenberg@stblaw.com

PALO ALTO

Alexis S. Coll-Very
650-251-5201
acoll-very@stblaw.com

James G. Kreissman
650-251-5080
jkreissman@stblaw.com

WASHINGTON, D.C.

Peter H. Bresnan
202-636-5569
pbresnan@stblaw.com

Peter C. Thomas
202-636-5535
pthomas@stblaw.com

Simpson Thacher litigators "work on high-profile and high-stakes securities matters, defending US financial institutions and Fortune 500 corporations against securities fraud allegations."

—THE LEGAL 500 UNITED STATES 2010

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3119 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Gaikokuho Jimu Bengoshi Jimusho
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000