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SECURITIES LAW ALERT

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This month's Alert discusses: the most recent jurisprudence applying *Morrison* to limit the extraterritorial reach of the securities laws; a Southern District of New York decision denying class certification in two mortgage-backed securities actions involving the Royal Bank of Scotland ("RBS"); a Southern District of New York decision denying class certification in the IMAX litigation on grounds that the lead plaintiff could not establish loss causation; and a Northern District of California decision declining to enforce Oracle's forum selection bylaw amendment in two pending derivative actions. We also review the securities litigation cases to watch in 2011 and provide a recap of the most noteworthy decisions of 2010.

Courts Continue to Apply *Morrison* to Limit the Extraterritorial Reach of the Federal Securities Laws

As we have previously reported, district courts have applied the Supreme Court's ruling in *Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010) to limit the extraterritorial reach of the federal securities law in a broad range of cases. (To read our prior discussions of *Morrison* jurisprudence, please click here for the October edition of the Alert, and here for the September edition.)

The trend continued this past month, with three notable Southern District of New York decisions applying *Morrison* in cases of first impression: one dismissing securities fraud actions against Porsche on the grounds that Section 10(b) does not govern swap agreements referencing foreign securities; another relying on *Morrison* to dismiss claims brought under the Securities Act of 1933 (the "'33 Act"), among other claims, in a subprime-related securities fraud litigation involving RBS; and a third dismissing Section 10(b) claims brought by Cayman-based hedge funds which purchased shares of U.S. penny stock companies in private placement transactions, on the grounds that the stocks were not sold on a domestic exchange.

The Southern District of New York Dismisses Securities Fraud Actions Against Porsche, Finding That Section 10(b) Does Not Protect Swap Agreements Referencing Foreign Securities

On December 30, 2010, the Southern District of New York dismissed six actions brought by 46 hedge funds against Germany-based Porsche Automobil Holding SE ("Porsche") and two of the company's former executives. *See Elliott Associates v. Porsche Automobil Holding SE*, No. 10 Civ. 0532, 2010 WL 5463846 (S.D.N.Y Dec. 30, 2010) (Baer, H.).[1] The funds had entered into securities swap agreements referencing the share price of another German car manufacturer, Volkswagen ("VW"). *See id*. at 1. According to the

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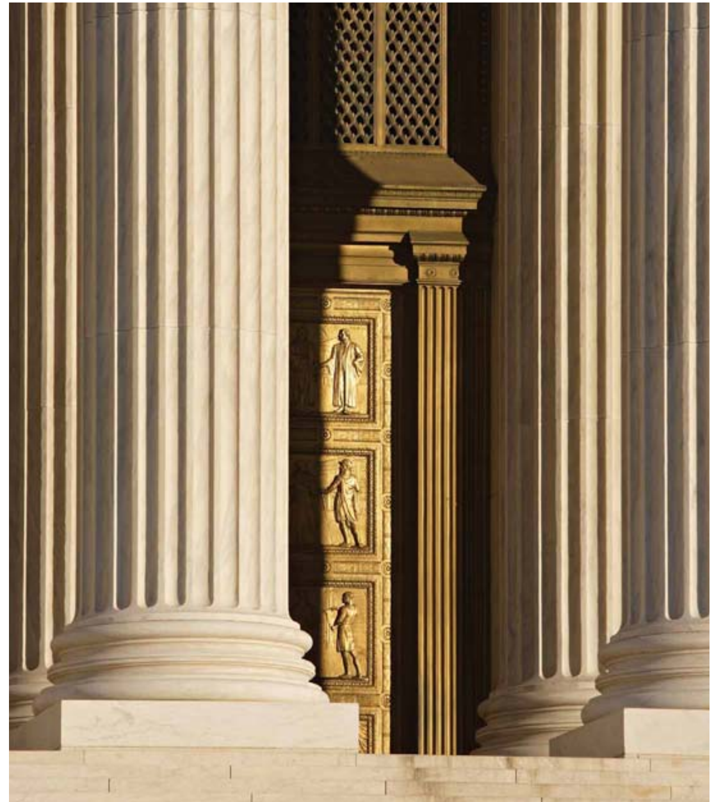
plaintiffs, Porsche and its executives "caused a dramatic rise in VW stock prices by buying nearly all of the freely-traded voting shares of VW as part of a secret plan to take over that company." *Id.* On October 26, 2008, when Porsche announced its VW holdings, the price of VW shares "shot up and caused enormous losses to Plaintiffs, who stood to benefit through their swap agreements from decreases in the VW share price." *Id.* The plaintiffs claimed that the defendants violated Section 10(b) and Rule 10b-5 "when Porsche falsely denied its intent to take over VW, and engaged in a series of manipulative derivative trades to hide the extent to which [Porsche] controlled VW shares." *Id.*

The Southern District of New York determined that the swap agreements at issue were outside of the reach of Section 10(b) following the Supreme Court's ruling in *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869 (2010). In *Morrison*, the Supreme Court held that Section 10(b) governs only "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869, 2884 (2010). "Since the [VW] swap agreements at issue … are clearly not listed on domestic exchanges," the *Porsche* court focused its inquiry on whether the swap agreements "constitute 'domestic transactions in other securities' within the ambit of § 10(b)." *Porsche*, 2010 WL 5463846 at *4.

The plaintiffs argued that the swap agreements constituted "domestic transactions" because the funds "signed confirmations for securities-based swap agreements in New York." *Id.* at *5. Although a number of the plaintiff hedge funds are organized under the laws of foreign jurisdictions, all of the plaintiff funds are managed by U.S.-based investment managers. The plaintiffs claimed that "investment decisions relating to their VW holdings were made by the U.S.-based investment managers," and "all steps necessary to transact the swap agreements were carried out in the United States." *Id.* at *2. The swap agreements at issue in the lead actions are "alleged to have been governed by New York law." *Id.*



In rejecting the plaintiffs' claims, the court took note of several Southern District of New York decisions holding that *Morrison* precludes Section 10(b) liability in cases involving securities sold on foreign exchanges, even where a domestic investor placed a "buy order" for those securities in the United States. *See id.* at *5 (*citing Plumbers Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.* No. 08 Civ. 1958, 2010 WL 3860397, at *6 (S.D.N.Y. Oct. 4, 2010); *In re Société Générale Sec. Litig.*, No. 08 Civ. 2495, 2010 WL 3910286, at *6 (S.D.N.Y. Sept. 29, 2010); *Cornwell v. Credit Suisse Group*, No. 08 Civ. 3758 (VM), 2010 WL 3069597, at *8 (S.D.N.Y. Jul. 27, 2010)). The *Porsche* court ultimately found that there is no meaningful "distinction, for the purposes of § 10(b), between a domestic 'buy order' for securities traded abroad and one party's execution in the U.S. of a swap agreement that references foreign securities." *Id.* at *5-*6.

Citing Supreme Court precedent "emphasiz[ing] the importance of 'economic reality' in determining whether derivative instruments fall within the ambit

of federal securities regulations," the *Porsche* court "consider[ed] the economics of the swaps to determine how to apply *Morrison* to securities-based swaps that reference stocks traded abroad." *Id.* at *6 (*citing Reves v. Ernst & Young*, 494 U.S. 56, 63 n.2 (1990); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)). The court found that the plaintiffs' own allegations confirmed that the swap agreements "were economically equivalent to the purchase of VW shares." *Id.* Accordingly, the *Porsche* court concluded that "the economic reality is that Plaintiffs' swap agreements are essentially 'transactions conducted upon foreign exchanges and markets,' and not 'domestic transactions' that merit the protection of § 10(b)." *Id.*

From a policy perspective, the Southern District of New York determined that to rule otherwise "would turn *Morrison*'s presumption against extraterritoriality on its head." *Id.* at *7. "In light of *Morrison*'s strong pronouncement that U.S. courts ought not to interfere with foreign securities regulation without a clear Congressional mandate," the *Porsche* court explained that it was "loathe to create a rule that would make foreign issuers with little relationship to the U.S. subject to suits here simply because a private party in this country entered into a derivatives contract that references the foreign issuer's stock." *Id.*

Notably, the Southern District of New York suggested that an issuer of foreign securities must engage in some level of active conduct in the United States before Section 10(b) liability can attach:

> Although *Morrison* permits a cause of action by a plaintiff who has concluded a 'domestic transaction in other securities,' this appears to mean 'purchases and sales of securities *explicitly solicited by the issuer in the U.S.*,' rather than transactions in foreign-traded securities—or swap agreements that reference them—where only the purchaser is located in the United States.

Id.

The Southern District of New York Applies *Morrison* to Dismiss '33 Act Claims and Section 10(b) Claims Involving Foreign-Traded RBS Shares

In a decision dated January 11, 2011, the Southern District of New York substantially limited the claims in the RBS securities fraud litigation. The court dismissed all claims, including those brought under the '33 Act, involving RBS ordinary shares traded on foreign exchanges. *See In re Royal Bank of Scotland Group PLC Securities Litigation*, No. 09 Civ. 300 (DAB), 2010 WL ____ (S.D.N.Y. January 11, 2011) (Batts, D.). Notably, the decision is the first to our knowledge to apply *Morrison* to claims under the '33 Act.

The plaintiffs brought suit in July 2009, prior to the Court's ruling in *Morrison*. The complaint alleged that "investors in RBS securities have suffered devastating losses as a direct consequence of RBS's undisclosed speculation in subprime assets, failure to value properly those assets and failure to take timely writedowns of goodwill related to" the company's October 2007 acquisition of ABN Amro Group, a Dutch banking entity. *Id.* at 11. RBS ordinary shares trade on the London Stock Exchange and the Euronext Amsterdam stock exchange; RBS American Depositary Receipts ("ADRs") trade on the New York Stock Exchange.

Following the *Morrison* decision, the defendants successfully moved to dismiss: (1) claims brought under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 on behalf of purchasers of RBS ordinary shares; (2) claims brought under the '33 Act on behalf of investors who tendered their shares in ABN Amro in exchange for RBS ordinary shares; and (3) claims brought under the '33 Act on behalf of investors who purchased RBS ordinary shares pursuant to an April 2008 rights issue. (The defendants did not move to dismiss claims brought under the '33 Act on behalf of purchasers of RBS preferred shares.)

The Court Dismisses Section 10(b) Claims Involving RBS Ordinary Shares

With respect to Section 10(b) claims involving RBS ordinary shares, the defendants argued that the claims "must be dismissed" because the complaint "does not allege that RBS ordinary shares were purchased or sold on an American stock exchange." *Id.* at 16. The plaintiffs responded by contending that "RBS's ordinary shares were clearly 'listed' (and registered) on the [New York Stock Exchange] in October 2007, for *Morrison* purposes, as RBS listed and registered American Depository Shares (and as evidenced by American Depository Receipts or 'ADRs')." *Id.* at 17.

The *RBS* court determined that the "[p]laintiffs' arguments fail under *Morrison*," explaining that "[t]he idea that a foreign company is subject to U.S. Securities laws everywhere it conducts foreign transactions merely because it has 'listed' some securities in the United States is simply contrary to the spirit of *Morrison*." *Id.* at 17-18. In a footnote, the court also noted that the plaintiffs' arguments were "badly undercut by the fact that the issuer in *Morrison*—National Australia Bank—had ADRs traded on the [New York Stock Exchange.]" *Id.* at 19, n. 9.

Looking beyond the text of the *Morrison* decision, the Southern District of New York found that the Court's "concern is on the true territorial location where the purchase or sale was executed and the particular securities exchange laws that governed the transaction." *Id.* at 18. The RBS court concluded that the "[p]laintiffs' [proposed] interpretation would be utterly inconsistent with the notion of avoiding the regulation of foreign exchanges." *Id.* Citing prior Southern District of New York decisions holding that Section 10(b) does not apply to claims involving securities traded on a foreign exchange under *Morrison*, the *RBS* court noted that "[t]his Court is not the first to read *Morrison* this way." *Id.* at 19.

The *RBS* court found similarly unavailing the plaintiffs' argument that "it is enough to allege that [the] [p]laintiffs are U.S. residents who were in the country when they decided to buy RBS shares." *Id.* at 20. Finding that this is "exactly the type of analysis that *Morrison* seeks to prevent," the Southern District of New York explained that the Supreme Court "did not reject the conduct and effects tests formerly employed by the various Circuits to replace it with another difficult-to-employ, fact intensive test." *Id.* at 20-21.

The Court Applies *Morrison* to Dismiss '33 Act Claims Involving RBS Ordinary Shares

The *RBS* court found that "[u]nder *Morrison*, the ['33] Act, like the Exchange Act, does not have extraterritorial reach." *Id.* at 24. The Southern District of New York was not moved by the plaintiffs' argument that "because *Morrison* involved solely an Exchange Act claim, it has no bearing on their ['33] Act claims." *Id.*, n. 11. The *RBS* court emphasized that the "*Morrison* Court clearly expressed that the territorial reach of the Exchange Act and ['33] Act involves the '*same* focus on domestic transactions.'" *Id.*

For the same reasons that the *RBS* court dismissed the plaintiffs' Section 10(b) claims involving RBS ordinary shares, the court dismissed the plaintiffs' claims under the '33 Act involving investors who exchanged ABN AMRO shares for RBS ordinary shares.

See id. at 24-26 (explaining that the RBS ordinary shares were "listed on foreign exchanges" and noting that "the Complaint is void of any allegations that the purchase of RBS ordinary shares pursuant to the Exchange Offer actually took place in the United States"). The court also dismissed '33 Act claims involving investors who purchased RBS ordinary shares pursuant to the April 2008 Rights Issue, explaining that "the shares issued pursuant to the Rights Issue were RBS ordinary shares, which the Court has already found to be deficient because of *Morrison*." *Id.* at 27.

The Court Finds that the Lead Plaintiffs Have No Standing to Bring Section 10(b) Claims Involving RBS ADRs Traded on the New York Stock Exchange

As to the plaintiffs' claims involving RBS ADRs traded on the New York Stock Exchange, the court dismissed these claims because "none of the Lead Plaintiffs … claim to have ever purchased ADRs representing ordinary shares on the NYSE." *Id.* at 21. The *RBS* court indicated that its dismissal of the ADR-related claims was not based on *Morrison*'s limits to the extraterritorial application of the securities laws. *See id.* (stating that "Defendants admit that under *Morrison*, trades on the NYSE fall within the territorial ambit of the Exchange Act").

Notably, the *RBS* court did not echo the holding in *In re Société Générale Sec. Litigation*, No. 08 Civ. 2495 (RMB), 2010 WL 3910286, (S.D.N.Y. Sept. 29, 2010) (Berman, R.), in which the Southern District of New York held that Section 10(b) does not apply to ADRs issued by a foreign company but traded on the over-the-counter market in the United States. *See id.* at *6 (dismissing claims involving ADRs issued by a French company on the grounds that "[t]rade in ADRs is considered to be a predominantly foreign securities transaction" because an ADR "represents one or more shares of a foreign stock or a fraction of a share").

The Southern District of New York Dismisses Section 10(b) Claims Brought by Foreign Hedge Funds Who Purchased U.S. Penny Stocks in Private Placement Transactions

On December 22, 2010, the Southern District of New York applied *Morrison* to foreclose Section 10(b) liability in a case brought by a group of Cayman Island-based hedge funds against foreign and domestic defendants in connection with alleged private placement purchases of "billions of shares of virtually worthless companies … that were incorporated in the United States." *Absolute Activist Value Master Fund Ltd. v. Homm*, No. 09 CV 08862, 2010 WL 5415885, at *2 (S.D.N.Y. Dec. 22, 2010) (Daniels, G). Although "the [p]enny [s]tocks were registered with the SEC," the securities "were not traded on a domestic exchange." *Id.* at *5. "In fact, the entire 'market' alleged [for the penny stocks] was the trading by and between the [Cayman-based] Funds." *Id.*

The *Absolute Activist* court concluded that "no transaction occurred in the United States." *Id.* Finding that "there was no sale of a security listed on an American Exchange," the court determined that "this appears to be precisely the type of case the Supreme Court had in mind when it issued *Morrison*." *Id.* The *Absolute* court reasoned that "[p]ermitting this case to move forward on the theory that any trade routed through the United States meets the *Morrison* standard would be the functional antithesis of *Morrison*'s directive." *Id.*

In the *Absolute Activist* court's view, it was also significant that the plaintiff hedge funds were based in the Cayman Islands, rather than the United States:

> By all accounts, [the] [p]laintiffs took great pains to avoid the regulations imposed by federal securities laws that apply to domestic market transactions. It would be illogical, and inconsistent with *Morrison*, to allow them [now]

to seek redress in this Court.

Id.

The Southern District of New York Court Denies Class Certification in Mortgage-Backed Securities Actions

On January 18, 2011, the Southern District of New York issued a ruling denying class certification motions filed in two mortgage-backed securities actions, holding that the plaintiffs failed to meet their burden under Rule 23(b)(3) to show that common issues predominated over issues affecting individual members of the proposed classes, and that class action treatment would be superior to individual actions. *See New Jersey Carpenters Vacation Fund., et. al., v. The Royal Bank of Scotland Group, plc, et. al.*, No. 08-cv-5093 (S.D.N.Y.) ("*HarborView*") and *New Jersey Carpenters Health Fund, et. al., v. Residential Capital, LLC, et. al.*, No. 08-cv-8781 (S.D.N.Y.) ("*RALI*"), slip. op. (S.D.N.Y. Jan. 18, 2011) (Baer, H.).

The plaintiffs in the *HarborView* and *RALI* actions assert claims under Sections 11, 12(a)(2) and 15 of the '33 Act as purchasers of mortgage-backed securities issued or underwritten by the defendants. The plaintiffs allege that the offering documents for the certificates they purchased failed to disclose that the originators of residential mortgage loans backing the certificates systematically disregarded underwriting guidelines. *Id*. at 1. The plaintiffs moved to certify classes including all purchasers of the certificates from the dates of their initial offerings through to the present. *Id*. at 1-2.

In its ruling on class certification, the court found that the plaintiffs had met their burden to satisfy Rule 23(a)'s requirements of numerosity, typicality, commonality and adequacy. *Id*. at 3-8. However,

with respect to the requirements of Rule 23(b)(3), the court held that the plaintiffs had "failed to meet their burden with respect to the issues of predominance and superiority, and those issues ultimately defeat Plaintiffs' motion." *Id*. at 9. Under Sections 11 and 12 of the '33 Act, defendants are not liable to a plaintiff that had knowledge of the facts that were allegedly misstated in or omitted from the offering materials for the securities. As the Southern District of New York observed, where a "defendant shows that broad knowledge of the alleged wrongful conduct 'existed throughout the community of market participants,'" such knowledge would precipitate individual inquiries into the knowledge of each class member and defeat predominance of common issues. *Id*. at 8 (*quoting In re Initial Pub. Offering Secs. Litig.*, 471 F.3d 24, 44 (2d Cir. 2006)). The court stated that it was "persuaded by *HarborView* Defendants' contention that different putative class members have different levels of knowledge regarding the underwriting guidelines and practices based on their respective levels of sophistication and time of purchase," and that such "facts illustrate sufficient differences in the knowledge of putative class members" to conclude that individual issues predominate. *Id*. at 10.

Specifically, the court referred to evidence the *HarborView* defendants submitted showing that the

proposed class included many sophisticated investors, such as large investment managers who touted their experience in mortgage-backed securities investments, financial institutions that the plaintiffs themselves had alleged in other lawsuits were aware of the origination practices that were the subject of the complaints, and government-sponsored entities that had issued trillions of dollars worth of mortgage-backed securities. *Id*. at 9-10. The court further noted that "different levels of knowledge can be imputed to investors who purchased at different times because throughout the relevant period more and more information became publicly available." *Id*. at 10. In sum, the court found that investors' different levels of knowledge of the matters that were the subject of the complaints meant that individual inquiries predominated over common class issues.

With respect to the superiority requirement under Rule 23(b)(3), the Southern District of New York ruled that class treatment was inappropriate, in part because "the proposed class consists of large, institutional and sophisticated investors with the financial resources and incentive to pursue their own claims." *Id*. at 11. In addition, the court found that, if a class were certified, any trial would require the court to hear "significant individualized evidence on, among other things, each purchaser's knowledge and damages." *Id*. at 12. The court noted that the lack of cohesion among members of the proposed class and the likelihood that "individual class members would have competing interests in controlling the prosecution of the action" further eroded "the superiority of class treatment." *Id*.

To our knowledge, the Southern District of New York's opinion is the first federal district court decision addressing class certification of claims under Sections 11 and 12 of the '33 Act among the numerous actions brought by purchasers of mortgage-backed securities that are currently pending across the country.

The Southern District of New York Denies Class Certification in the *IMAX* Litigation, Finding that the Proposed Lead Plaintiff Could Not Show Loss Causation

In late December, the Southern District of New York denied a motion for class certification in the *IMAX* securities fraud litigation on the grounds that proposed lead plaintiff Snow Capital Investment Partners, L.P. could not establish loss causation and therefore could not satisfy the typicality requirement of Rule 23(a)(3) of the Federal Rules of Civil Procedure. *See In re Imax Sec. Litig*., No. 06 Civ. 6128, 2010 WL 5185076 (S.D.N.Y. Dec. 22, 2010) (Buchwald, N.). The case involved allegations that IMAX Corporation "issued materially false and misleading statements concerning IMAX's accounting of theater system revenue" between February 27, 2003 and July 27, 2007. *Id*. at *1.

Background

On February 17, 2006, IMAX issued a press release announcing its 2005 financials and reporting the installation of 14 theater systems during the fourth quarter of 2005. In its 2005 Form 10-K, filed on March 9, 2006, IMAX announced its "record" number of theater system installations in the last quarter of 2005 and reported $35.1 million in revenue for the quarter. *Id*.

Five months later, on August 9, 2006, IMAX issued a press release announcing that the Securities & Exchange Commission ("SEC") had initiated an "informal inquiry … regarding the Company's timing of revenue recognition, including its application of multiple element arrangement accounting to its revenue recognition for theatre systems." *Id*. at *2. Under the multiple element arrangement ("MEA") accounting methodology, "'the revenues associated with different elements of an IMAX theater system

contract are segregated and can be recognized in different periods.'" *Id*. The August 9, 2006 Press Release acknowledged that the company "'recognized revenue in the fourth quarter of 2005 on 10 theatre installations in theatres which did not open in that quarter,'" and noted that MEA accounting had "'similarly been applied to one theatre installation in the second quarter of 2006.'" *Id*. In addition to addressing the SEC inquiry, the August 9, 2006 Press Release also disclosed that "discussions with potential buyers and strategic partners had faltered." *Id*. On August 10, 2006, the price of IMAX shares fell by $3.90, to $5.73 per share. *Id*.

More than seven months later, on March 29, 2007, IMAX announced that it was expanding the scope of its review of the accounting methodology used to calculate past financial results. *Id*. IMAX stated that as a result of this "'expanded review,'" the company "'may determine that it is necessary to restate additional items beyond the previously identified errors.'" *Id*.

On July 20, 2007, IMAX filed its 2006 Form 10-K, which "included a restatement of its financial results for fiscal years 2002 through the first three quarters of 2006." *Id*. The 2006 10-K explained that IMAX had revised its accounting methodology to permit the recognition of revenue for a theatre installation only after the receipt of "written customer acceptance" of a fully-operational system, or "the public opening of the theater." *Id*. Under the restated financial results, "16 installation transactions representing $25.4 million in revenue shifted between quarters in their originally reported years, and 14 installation transactions representing $27.1 million in revenue shifted between fiscal years." *Id*. at *3.

Proposed lead plaintiff Snow Capital purchased shares of IMAX stock on three dates, each prior to the close of the fourth quarter of 2005: December 14, 2004; October 3, 2005; and November 3, 2005. *Id*. at *8. Snow Capital sold its IMAX shares on February 7, 2005 and August 10, 2006. The August 2006 sale liquidated all of Snow Capital's IMAX holdings. *See id*.

The Court Finds That Snow Capital Cannot Be Named Class Representative Because It Cannot Demonstrate Loss Causation

Pursuant to Federal Rule of Civil Procedure 23(a), "the claims or defenses of the representative parties" in a proposed class action must be "typical of the claims or defenses of the class." Fed. R. Civ. P. 23(a)(3). The Southern District of New York began its analysis of the typicality prong by noting that "[i]n order to be named Class Representative, Snow Capital must show, by a preponderance of the evidence, that its claims are typical of the claims of the class, and that it is not subject to any unique defenses which threaten to become the focus of the litigation." *IMAX*, 2010 WL 5185076, at *6 (internal quotations omitted).

The defendants contended that "Snow Capital cannot satisfy Rule 23(a)(3)'s typicality requirement because, amongst other reasons, it cannot establish loss causation." *Id*. at *7. Citing the recent case of *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 574 F.3d 29 (2d Cir. 2009), the Southern District of New York agreed that whether or not a proposed class representative can show loss causation is "relevant to Rule 23(a)." *Id*.

(internal quotations omitted).

In *Flag Telecom*, the Second Circuit held that the district court had erred by naming as a class representative an in-and-out trader who had sold his stock prior to an alleged corrective disclosure. The *Flag Telecom* court found that the plaintiffs "have not presented sufficient evidence to demonstrate that the in-and-out traders will even 'conceivably' be able to prove loss causation as a matter of law, and that therefore, they should not have been included in the certified class." 574 F.3d at 40.

The defendants argued that Snow Capital could not establish loss causation because it "purchased all of its IMAX stock before IMAX's financials for the fourth quarter of 2005 were released on February 17, 2006" and "sold its entire remaining interest in IMAX on August 10, 2006—before any statements alleged to have been curative … regarding the alleged misrepresentations upon which Snow could have relied for its purchase of IMAX stock." *IMAX*, 2010 WL 5185076, at *8. In the defendants' view, the August 9, 2006 Press Release "cannot have been a corrective disclosure for Snow [Capital]" since it "only related to theater systems recognized in or after the fourth quarter of 2005." *Id.*

Snow Capital responded by claiming that the August 9, 2006 Press Release did, in fact, constitute a corrective disclosure because the scope of IMAX's statement implicated much more than fourth quarter 2005 financial results. The August 9, 2006 Press Release allegedly "raised a cloud of uncertainty that the SEC's investigation might extend back to revenue recognition problems before the fourth quarter of 2005," *id.* at *11, and indicated "problems and potential problems that convinced [Richard Snow, the founder and president of Snow Capital] to sell Snow Capital's IMAX securities the following day." *Id.* at *10.

The Southern District of New York emphasized that "a corrective disclosure for the purposes of loss causation should place investors on notice of the type of specific fraudulent accounting practices that plaintiffs allege." *Id.* at *9 (internal citations and alterations omitted). "[W]hile the [August 9, 2006] disclosure of the SEC investigation specifically addressed IMAX's MEA accounting policy that was applied in 4Q 2005," the court found that the press release "did not address, or suggest an investigation into, IMAX's accounting practices in earlier periods." *Id.* The court determined that the August 9, 2006 Press Release "was not a corrective disclosure for alleged misstatements beyond those that fall within both the temporal (4Q 2005 and later) and topical (the application of MEA accounting described in the announcement) limitations of the disclosure itself." *Id.* at *10.

With respect to Snow Capital's claim that where "losses were the result of a sustained course of conduct, a 'class need not be represented by an investor who purchased at each point during the class period,'" the court found that this "general proposition … does not apply to the situation at bar." *Id.* at *12. The court concluded that the alleged IMAX fraud did not constitute a "'sustained course of conduct' or 'common scheme to defraud,' to the limited extent that those terms are … used to justify the appointment of a class representative who purchased prior to the end of the class period." *Id.* Here, the "application of IMAX's revenue recognition policy changed throughout the class period, and the first corrective disclosure addressed alleged misstatements issued after Snow's purchases." *Id.*

The Southern District of New York determined that "at a minimum, [Snow Capital] is subject to unique defenses which may threaten to become the focus of the litigation (and which would not be the focus of the litigation for class members who either purchased shares after February 17, 2006, or who purchased prior to February 17, 2006 and held through a subsequent alleged corrective disclosure)." *Id.* at *14. Finding that "Snow Capital cannot establish loss causation," the court concluded that "we cannot certify a class with [Snow Capital] as class representative." *Id.*

The Northern District of California Declines to Enforce Oracle's Forum Selection Bylaw Amendment in Two Pending Derivative Actions

In the first week of January, the Northern District of California denied an effort by Oracle Corporation to dismiss on grounds of improper venue two related derivative actions arising out of an "alleged overbilling scheme" in connection with sales of software and licenses to the United States government between 1998 and 2006. *See Galaviz v. Berg*, Nos. C 10-3392 RS, C 10-4233 RS, 2011 WL 135215 (N.D.Cal. Jan. 3, 2011) (Seeborg, R.).

Oracle claimed that pursuant to a 2006 bylaw amendment establishing a forum selection provision for derivative suits, the actions could only be brought in the Chancery Court of Delaware. All of the directors named as individual defendants were "present at the meeting where the bylaws were amended, and they unanimously approved the resolution." *Id.* at *1. The amendment was adopted "well before" the filing of a *qui tam* action in connection with the alleged overbilling, and prior to the commencement of the instant derivative actions, but "after the purported overbilling scheme had allegedly been ongoing for several years." *Id.*

The dismissal motions presented a question of first impression: "[m]ay corporate directors control the venue for shareholder derivative actions brought against them by adopting a bylaw purporting to require that such cases be filed in a particular forum?" *Id.* Venue provisions in corporate bylaws are "reportedly a recent phenomenon, apparently occasioned by" the Delaware Chancery Court's suggestion that:

> [I]f boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes.

Id. at *2 (*quoting In re Revlon, Inc. Shareholders Litig.*, 990 A.2d 940, 960 (Del. Ch. 2010)). Prior to the *Oracle* decision, "no court ha[d] previously ruled on the enforceability of a venue provision for derivative actions contained in corporate bylaws." *Id.*

The Northern District of California held that the Oracle forum selection bylaw amendment was unenforceable under "federal procedural law that controls such venue issues." *Id.* at *1. The court found that "[a] [forum selection] bylaw unilaterally adopted by directors … stands on a different footing" from "legally enforceable forum selection clauses" in contracts because of the lack of mutual consent. *Id.* Even where contracts are offered on a "'take it or leave it' basis," the court explained that "a plaintiff can be said to have consented to the forum selection clause when he or she elected to enter into that contract." *Id.* Here, however, the court found that "there [was] no element of mutual consent to the forum choice at all, at least with respect to shareholders who purchased their shares prior to the time the bylaw was adopted." *Id.* The court emphasized that "the venue provision was unilaterally adopted by the directors who are defendants in this action, after the majority of the purported wrongdoing is alleged to have occurred, and without the consent of existing shareholders who acquired their shares when no such bylaw was in effect." *Id.* at *4.

Oracle argued that "its bylaws can and should be treated as any other contract," and took the position that the bylaw amendment should be examined under the same standards used in the Ninth Circuit to assess the validity of contractual forum selection clauses. *Id*. at *3. The Northern District of California acknowledged that "there would be little basis to decline to enforce the venue provision of Oracle's bylaws" under the rule set forth in *R.A. Argueta v. Banco Mexicano, S.A.*, 87 F.3d 320 (9th Cir. 1996). *Id*. However, the court agreed with the plaintiffs that "the test for [assessing the] validity of contractual forum clauses is simply inapplicable here" because "the essential element of mutual consent is lacking." *Id*. at *3. The court explained that "[u]nder contract law, a party's consent to a written agreement may serve as consent to all the terms therein, whether or not all of them were specifically negotiated or even read." *Id*. at *4. However, "it does not follow that a contracting party may thereafter *unilaterally* add or modify contractual provisions." *Id*. (emphasis added).

The Northern District of California found it incongruous for Oracle to argue that *contract* law governed the enforcement of the forum selection bylaw amendment, while *corporate* law applied to the bylaw amendment process:

> Oracle cannot persuasively contend that its bylaws are like any other contract—and that therefore the *Argueta* factors control here—while simultaneously arguing that it was permitted under corporate law to amend those bylaws in a manner that it could not have achieved under contract law.

Id. The court found it significant that Oracle was unable to "point[ ] to any commercial contract case upholding a venue provision that was inserted by a purported unilateral amendment to existing contract terms." *Id*.

As to the plaintiffs' contention that under Delaware law, "only a charter amendment, approved by a majority of the shareholders, could properly limit venue in derivative actions against the corporation," *id*. at *4, the court agreed that "were a majority of shareholders to approve such a charter amendment, the arguments for treating the venue provision like those in commercial contracts would be much stronger, even in the case of a plaintiff shareholder who had personally voted against the amendment." *Id*. Nonetheless, the Northern District of California determined that it "need not … decide whether the adoption of Oracle's venue bylaw was within the directors' powers as a matter of Delaware law" because "the enforceability of a purported venue requirement is a matter of federal common law." *Id*.

Securities Cases to Watch in 2011

The coming year promises interesting developments in the area of securities litigation. With three cases pending before the Supreme Court—two of which have already been argued—there may be significant new guidance in 2011 on the scope of secondary actor liability, the relevance of loss causation at the class certification stage, and the disclosure obligations of pharmaceutical companies with respect to adverse event reports. The Court may also choose to address corrective disclosures in the context of loss causation by granting *certiorari* in the *Apollo* litigation.

We will be monitoring each of the below cases closely. As always, we will report any significant new developments in future editions of the Alert.

Janus Capital Group, Inc. v. First Derivative Traders

On December 7, 2010, the Supreme Court heard oral arguments in *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525. The case reviews a Fourth Circuit decision reversing the dismissal of securities fraud

claims against Janus Capital Management, LLC ("JCM"), the investment adviser to the Janus family of mutual funds. *See In re Mut. Funds. Inv. Litig.*, 566 F.3d 111, 115 (4th Cir. 2009) ("*Janus I*"). At issue is whether JCM can be held primarily liable under Section 10(b) for *helping* to prepare allegedly misleading Janus fund prospectuses, even though the prospectuses were not actually attributed to JCM.

The Fourth Circuit held that allegations that JCM "helped draft" and "participat[ed] in the writing and dissemination of the prospectuses" were sufficient to state a claim that JCM had "*made* the misleading statements" in the prospectuses for purposes of Section 10(b) liability. *Id.* at 121. Given the "publicly disclosed responsibilities of JCM" as the funds' investment advisor, the Fourth Circuit determined that "interested investors would infer that JCM played a role in preparing or approving the content of the Janus fund prospectuses" even though the prospectuses were not specifically attributed to JCM. *Id.* at 127.

On June 28, 2010, the Supreme Court granted *certiorari* to decide the following two questions:

> 1. Whether the Fourth Circuit erred in concluding … that a service provider can be held primarily liable in a private securities fraud action for "help[ing]" or "participating in" another company's misstatements.
>
> 2. Whether the Fourth Circuit erred in concluding … that a service provider can be held primarily liable in a private securities fraud action for statements that were not directly and contemporaneously attributed to the service provider.

Order Granting Petition for *Certiorari*.

With respect to the first question, the Janus petitioner-defendants contended that the Fourth Circuit's decision is "flatly inconsistent with *Central Bank* and *Stoneridge*: There is no private liability for 'helping' (*i.e.* aiding) another company." Brief

for Petitioners at 10. As to the second question, the Janus entities argued that "[t]he majority of courts of appeals have recognized that direct attribution is a prerequisite to presuming reliance in cases against secondary actors." *Id.* at 12. To date, the Second, Fifth and Eleventh Circuits have adopted a bright-line attribution rule for secondary actor liability, and the Tenth Circuit has signaled its approval of the rule. In the Fourth and Ninth Circuits, however, secondary actors can be held liable even for statements that are not directly attributed to them at the time the statements are made.

Lead plaintiff-respondent First Derivative Traders argued that JCM did not simply assist the Janus funds in making misstatements; rather, "JCM both wrote (*i.e.* created) its policy regarding market timing in the Janus Funds and caused the Funds' prospectuses to be issued and disseminated containing that policy." Brief for Respondents at 18-19. Viewed in the context of the "well-recognized and uniquely close relationship between a mutual fund and its investment adviser," *id.* at 21, First Derivative Traders contended that these allegations "suffice[ ] to plead that JCM *made* the misrepresentations in the Funds' prospectuses regarding its market-timing policy." *Id.* at 19 (emphasis added). As to the question of whether attribution is a prerequisite for presuming reliance, First Derivative Traders argued that "[i]mposing a new direct-attribution requirement in § 10(b) actions would

frustrate Congress's purposes of promoting honest securities markets and investor confidence." *Id*. at 13.

The United States filed an amicus brief in support of the lead plaintiff-respondent. In the Government's view, "one can make a statement by creating or writing it, even if the statement's creator is not expressly identified." Brief for the United States as Amicus Curiae Supporting Respondent at 14 (internal quotations and alterations omitted). The Government argued that "[r]eading the word 'make' to apply to the acts of someone who 'creates' an untrue statement that is then transmitted to the market by another person or entity is especially appropriate in the context of Rule 10b-5(b)" because "[b]oth the statute and the rule encompass 'any person' who engages 'directly or *indirectly*' in the proscribed conduct." *Id*. at 15. The Government further contended that JCM should be considered a primary actor, rather than a secondary actor: "Unlike a typical secondary actor such as a lawyer, accountant or bank … an investment adviser's unique and close relationship with a mutual fund makes it essentially a corporate insider." *Id*. at 17 (internal quotations and citation omitted). With respect to the direct attribution question, the Government argued that "[n]othing in this Court's articulations of the fraud-on-the-market presumption suggests that the presumption depends on contemporaneous public knowledge of the identity of a public statement's author." *Id*. at 27.

During oral arguments on December 7, 2010, Justice Scalia expressed skepticism as to the claim that JCM "made" the statements in the mutual fund prospectuses at issue: "If someone writes a speech for me, one can say he drafted the speech, but I make the speech." Justice Sotomayor, on the other hand, asked whether, under the view advanced by the Janus defendants, a company could escape liability under Section 10(b) by using a conduit to make misleading statements to the market: "Do you mean to say to me that puppets become a legal defense for someone who intentionally manipulates the market information?"

On behalf of the United States as amicus curiae, the Assistant to the Solicitor General advocated broad liability for secondary actors under Section 10(b): "[I]f [one] writes the statement or provides the false information that's used to construct the statement or allows the statement to be attributed to him," that person should be considered "a primary violator." The United States took the position that "attribution to the actor is not necessary for the actor's liability for a statement." Justice Kagan voiced concern with the scope of the government's view, noting that it "is really pretty broad" and "might apply to a range of factual situations that are not before us."

The Supreme Court's ruling in *Janus* may have far-reaching ramifications for secondary actors who play a role in preparing an issuer's offering materials and other public statements. At a minimum, the *Janus* decision will likely resolve the circuit split on the question of whether attribution is required for secondary actor liability under Section 10(b).

Erica P. John Fund, Inc. v. Halliburton Co.

On January 7th, 2011, the Supreme Court granted *certiorari* in the case of *Erica P. John Fund, Inc. v. Halliburton Co.*, No. 09-1403. The case reviews a Fifth Circuit decision affirming the denial of class certification where the plaintiff had failed to "prove loss causation, i.e., that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses." *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 334 (5th Cir. 2010).

Following the rule established in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261, 265 (5th Cir. 2007), the *Halliburton* court explained that plaintiffs seeking class certification must "'establish loss causation in order to trigger the fraud-on-the-market presumption.'" *Halliburton*, 597 F.3d at 335. To qualify for class certification in the Fifth Circuit, plaintiffs must show, "by a preponderance of all admissible evidence," that "an alleged misstatement 'actually moved the market.'" *Id*. The *Halliburton* court

squarely rejected the plaintiffs' argument that the *Oscar* decision is "contrary to Supreme Court and sister circuit precedent." *Id*. at 334, n. 2 (noting that the "Plaintiff may not assail *Oscar* as wrongly decided, as we are bound by the panel decision").

Several months after the *Halliburton* decision, the Seventh Circuit reached the opposite conclusion, finding that the stock price impact of an alleged misstatement or omission is a merits issue rather than a prerequisite for class certification. *See Schleicher v. Wendt*, 618 F.3d 679 (7th Cir. 2010). Under the Seventh Circuit's holding, the proper time to pin down "*when* the stock's price was affected by any fraud" is "[a]fter a class has been certified, and other elements of the claim have been established." *Id*. at 687. The *Schleicher* court criticized the Fifth Circuit's approach as a "go-it-alone strategy" that is "not compatible with this circuit's decisional law." *Id*.

The Supreme Court granted *certiorari* of the following two questions:

> 1. Whether the Fifth Circuit correctly held … that plaintiffs in securities fraud actions … must establish loss causation at class certification by a preponderance of admissible evidence without merits discovery.
>
> 2. Whether the Fifth Circuit improperly considered the merits of the underlying litigation … when it held that a plaintiff must establish loss causation to invoke the fraud on the market presumption …

Order Granting Petition for *Certiorari*.

In their Petition for *Certiorari*, the plaintiffs contended that "the Fifth Circuit imposes a substantial burden beyond that required by [*Basic Inc. v. Levinson*, 485 U.S. 224 (1988)], and in violation of *Basic*." *Id*. at 20. Challenging the Fifth Circuit's "exceedingly high standard for certifying a securities class action," the plaintiffs emphasized that "[n]o other circuit has followed [this] rule." *Id*. at 3. The plaintiffs further contended that "[t]he Fifth Circuit's requirement … interjects a premature and improper merits examination into the certification inquiry," in violation of "Supreme Court precedent and Federal Rule of Civil Procedure 23." Reply Brief for Petitioner at 1.

The defendants responded by arguing that under *Basic*, "a court may refuse to certify a class under the fraud-on-the-market theory" when "the evidence shows that a misrepresentation had no impact on the market price—and thus did not cause any loss." *See* Respondents' Supplemental Brief at 1-2. Downplaying the extent of the alleged circuit split, the defendants contended that "the Second Circuit joins the Fifth Circuit in considering loss causation at the class-certification stage" and claimed that "the Seventh Circuit simply has not addressed whether a defendant can rebut the *Basic* presumption—and thus defeat class certification—by demonstrating the absence of loss causation." *Id*. at 2. The defendants posited that "it is uncertain whether any circuit would certify a class where, as here, the evidence indisputably shows that the alleged misrepresentations did not cause any loss." *Id*. at 4.

Before granting *certiorari*, the Court requested the Acting Solicitor General's input. The Acting Solicitor General recommended that the petition be granted, echoing the plaintiffs' position that "[n]othing in *Basic* … supports the Fifth Circuit's approach." Brief for the United States as Amicus Curiae at 5. In the

Government's view, "the only relevant question at the class-certification stage is whether resolution of the loss-causation issue can be expected to turn on proof that is common to class members generally." *Id.* at 9.

The Court's ruling in *Halliburton* will likely clarify the extent to which plaintiffs must establish loss causation at the class certification stage. A date for oral argument has yet to be set, but the case is on the docket for October Term 2010.

Matrixx Initiatives, Inc. v. Siracusano

On January 10, 2011, the Supreme Court heard oral arguments in the case of *Matrixx Initiatives, Inc. v. Siracusano*, No. 09-1156. The case reviews a Ninth Circuit decision reversing the dismissal of a securities fraud action against Matrixx Initiatives, a pharmaceutical company. *See Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d 1167 (9th Cir. 2009) ("*Matrixx II*"). At issue is whether Matrixx can be held liable for failing to disclose adverse event reports that are not alleged to have been statistically significant.

In April 2004, investors brought suit against Matrixx, claiming that the company had withheld information regarding purported claims that its over-the-counter cold remedy, Zicam, caused anosmia, the loss of sense of smell. The District of Arizona dismissed the complaint, concluding that the omission was not material because the plaintiffs had "failed to present evidence of a statistically significant correlation between the use of Zicam and anosmia." *Siracusano v. Matrixx Initiatives, Inc.*, Nos. CV 04 0886(PHX MHM), CV 04 1012 (PHX MHM) 2005 WL 3970117, at *7 (D. Ariz. Dec. 15, 2005) ("*Matrixx I*"). Relying on the Second Circuit's ruling in *In re Carter-Wallace, Inc. Securities Litigation*, 220 F.3d 36 (2d. Cir. 2000), the district court determined that "adverse information related to the safety of a product is not material unless such reports provide reliable statistically significant evidence that a drug is unsafe." *Matrixx I*, 2005 WL 3970117, at *5.

The Ninth Circuit found that the district court had "erred in relying on the statistical significance standard to conclude that Appellants failed adequately to allege materiality." *Matrixx II*, 585 F.3d at 1178. Citing *Basic*, the Ninth Circuit explained that the question of materiality cannot be resolved by bright-line rules but instead requires "delicate assessments of the inferences a reasonable shareholder would draw from a given set of facts." *Id.* (internal quotations omitted).

On June 14, 2010, the Court granted *certiorari* of the following question:

> Whether a plaintiff can state a claim under § 10(b) of the Securities Exchange Act and SEC Rule 10b-5 based on a pharmaceutical company's nondisclosure of adverse event reports even though the reports are not alleged to be statistically significant.

Order Granting Petition for *Certiorari.*

Matrixx argued that "a plaintiff alleging that a company failed to disclose [adverse event reports] should be required to allege facts establishing that the [adverse event reports] represented statistically significant evidence that a company's product was a cause of the reported event." Brief for Petitioners at 13. Without a statistical significance standard in place, Matrixx claimed that pharmaceutical companies would disclose all adverse event reports "to avoid potential securities fraud liability." *Id.* The market would be "flood[ed] … with trivial or meaningless information that would only obscure genuinely important information and thereby obscure sound investment decisionmaking." *Id.*

In response, the plaintiff-respondents argued that "[s]tatistical significance is not the same as practical importance" and emphasized that "practical importance is what matters for materiality." Brief for Respondents at 22. The plaintiff-respondents contended that "*Basic* forecloses a rule that would make any fact, including statistical significance, a categorical prerequisite for materiality in securities-fraud cases." *Id.* at 22. They cautioned that "requiring a statistical significance finding as categorically necessary before

information about adverse drugs is deemed material would be underinclusive" and would "authorize[] drug companies to conceal information that reasonable investors would consider important." *Id.* at 41.

During oral arguments on January 10, 2011, several of the Justices raised concerns about the practical effects of implementing a statistical-significance standard for materiality. Chief Justice Roberts focused on the stock price impact of adverse drug-related information, rather than its scientific validity: "I'm an investor in Matrixx; I worry whether my stock price is going to go down. You can have some psychic come out and say 'Zicam is going to cause a disease' with no support whatsoever, but if it causes the stock to go down 20 percent, it seems to me that's material." Justice Breyer noted that there might be information that could be "devastating to a drug even though there isn't one person yet who has been hurt." He expressed reluctance to implement a bright-line rule: "I can't see how we can say this statistical evidence always works or doesn't work."

In contrast to the Ninth Circuit's view, the First, Second, and Third Circuits have indicated their approval of a statistical significance standard for the disclosure of adverse event reports. The Court's ruling will likely resolve this circuit split. Depending on how the Court approaches the *Matrixx* case, the decision may also yield more generally-applicable guidance on materiality in the context of securities fraud claims.

Apollo Group, Inc. v. Policemen's Annuity and Benefit Fund of Chicago

Presently pending before the Supreme Court is a petition for *certiorari* in the case of *Apollo Group, Inc. v. Policemen's Annuity and Benefit Fund of Chicago*, No. 10-649, which seeks review of a Ninth Circuit decision reinstating a jury verdict against Apollo Group, Inc., the parent company of the University of Phoenix. The plaintiff pension fund charged Apollo with making false and misleading statements in connection with a Department of Education review of recruiting practices at the University of Phoenix.

On September 7, 2004, Apollo announced that the University had reached a settlement with the government for $9.8 million. News of the settlement did not result in a major change in Apollo's stock price. It was not until two weeks later, after a securities analyst downgraded her outlook for Apollo, that the stock price dropped.

At trial, the court instructed the jury that loss causation could only be found if the analyst reports at issue constituted "corrective disclosures." *In re Apollo Group, Inc. Sec. Litig.*, No. CV 04-2147-PHX-JAT, 2008 WL 3072731, at *1 (D. Ariz. Aug. 4, 2008). The jury found in favor of the plaintiff. *Id.* Upon a motion for judgment as a matter of law, the District of Arizona vacated the jury verdict, finding that "the evidence was insufficient to show" that the analyst reports in question were "in fact corrective." *Id.* at *3.

In an unpublished three-page decision dated March 3, 2010, the Ninth Circuit held that the district court had erred in granting Apollo judgment as a matter of law. *See In re Apollo Group, Inc. Sec. Litig.*, No. 08-16971 (9th Cir. March 3, 2010). The court concluded that "[t]he jury could have reasonably found that the UBS reports following various newspaper articles were 'corrective disclosures' providing additional or more authoritative fraud-related information that deflated the stock price." *Id.* at 2.

Apollo filed a petition for *certiorari* seeking the Court's review on two questions:

1. … Where a plaintiff invokes the efficient market theory to avoid having to prove reliance, is the plaintiff barred from trying to prove loss causation based on a decline in price that happened weeks or months after the corrective disclosure?

2. If the stock price does not decline after the facts are publicly revealed, but does decline after an analyst issues a report that merely synthesizes and comments upon the already-public information, is the plaintiff barred from treating that report as a fraud-revealing corrective disclosure that suffices to prove loss causation?

Petition for *Certiorari* at i. Citing a circuit split with respect to the first question, Apollo argued that "[o]n one side of the spectrum is the view (adopted in [the Second, Third and Eleventh Circuits]) that in an efficient market, the stock must decline immediately after the alleged corrective statement." *Id*. at 4; *see also id*. at 15-18. "On the other side of the spectrum is the view—adopted by [the Fifth, Sixth and Ninth Circuits]—that for purposes of determining loss causation plaintiffs can point to purported corrective disclosures that do not yield price declines for days, weeks or even months." *Id*. at 4; *see also id*. at 18-20.

With respect to the second question, Apollo contended that "[f]ive circuits have held that the recharacterization or analysis of previously disclosed facts—or opinions or predictions regarding the impact of such facts—*cannot* be a corrective disclosure." *Id*. at 5. Apollo argued that "[t]he Ninth Circuit stands alone in holding that an analyst's opinions, predictions, and analyses of previously disclosed facts can be a corrective disclosure." *Id*.

Central to the *Apollo* dispute is the application of the efficient market theory. In Apollo's view, the Ninth Circuit's approach to the efficient market theory is internally inconsistent: "It posits a market that is perfectly efficient, speedy and omniscient for purposes of granting plaintiffs the enormous benefit of the presumption of reliance on misrepresentations, but horribly inefficient, sluggish, and doltish in response to corrective disclosures." *Id*.

A number of amicus briefs have already been filed, including a brief from the National Association of Manufacturers supporting the grant of the petition.

Should the Court choose to hear the case, the decision may provide clarity on the amount of time that may elapse between an alleged corrective disclosure and a subsequent price drop for purposes of loss causation; and whether a recharacterization or analysis of previously disclosed facts can constitute a corrective disclosure.

Noteworthy Decisions of 2010

The past year brought a number of significant changes to the securities litigation landscape. Here we review a number of the most noteworthy decisions of 2010.

Morrison v. National Australia Bank Ltd.

Without a doubt, the Supreme Court's sweeping ruling in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010) merits a first-place position on any list of the most important securities law rulings of 2010. The Court defined the geographic boundaries of Section 10(b) when it determined that "there is no affirmative indication in the Exchange Act that § 10(b) applies extraterritorially, and we therefore conclude that it does not." *Id*. at 2883. In its decision, the Court held that Section 10(b) only governs "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." *Id*. at 2884.

Prior to the *Morrison* ruling, courts around the country had relied on the Second Circuit's "conduct" and "effects" tests to determine the availability

of Section 10(b) relief in cases involving foreign securities transactions. The Supreme Court rejected both assessments as "vague formulations" that have resulted in "the unpredictable and inconsistent application of § 10(b) to transnational cases." *Id*. at 2879-2880. Under the Court's new "transactional test," Section 10(b) applies only if "the purchase or sale is made in the United States" or "involves a security listed on a domestic exchange." *Id*. at 2886. The Court explained that this rubric avoids "interference with foreign securities regulation that application of §10(b) abroad would produce." *Id*.

Although the Court limited the reach of Section 10(b) to "domestic transactions," the *Morrison* decision did not provide complete guidance as to when a "purchase or sale" is considered to have been "made *in the United States*." *Id*. at 2886 (emphasis added). District courts were soon faced with the question of what constitutes a "domestic transaction," particularly in the context of U.S. purchasers of securities traded on foreign exchanges.

The Central District of California was among the first to apply *Morrison* to domestic purchases of foreign securities. *See Stackhouse v. Toyota Motor Co.*, No. CV 10-0922 (AJWx), 2010 WL 3377409 (C.D. Cal. July 16, 2010) (Fischer, D). In considering the claims of U.S. purchasers of Toyota common stock traded on the Tokyo Stock Exchange, the *Stackhouse* court noted that:

> One view of the Supreme Court's holding is that if the purchaser or seller resides in the United States and completes a transaction on a foreign exchange from the United States, the purchase or sale has taken place in the United States.

Id. at *1. However, the Central District of California adopted the "alternative view" that "because the actual transaction takes place on the foreign exchange, the purchaser or seller has figuratively traveled to that foreign exchange … to complete the transaction." *Id*. The *Stackhouse* court found that this "latter position is better supported by *Morrison*." *Id*.

Less than two weeks after the *Stackhouse* ruling, the Southern District of New York articulated a bright-line rule: Section 10(b) does "*not* apply to transactions involving … a purchase or sale, wherever it occurs, of securities listed only on a foreign exchange." *Cornwell v. Credit Suisse Group*, No. 08 Civ. 3758 (VM), 2010 WL 3069597, at *3 (S.D.N.Y. July 27, 2010) (Marrero, V.). The *Cornwell* court determined that *Morrison* forecloses Section 10(b) relief for all "foreign securities trades executed on foreign exchanges even if purchased or sold by American investors, and even if some aspects of the transaction occurred in the United States." *Id*. at *5.

These early post-*Morrison* cases established a trend—which has since continued—of broadly applying the Supreme Court's ruling to dismiss a wide range of claims involving foreign securities transactions. For now, courts appear inclined to find that "[t]he standard the *Morrison* Court promulgated to govern the application of §10(b) in transnational securities purchases and sales does not leave open any … back doors, loopholes or wiggle room." *Cornwell*, 2010 WL 3069597, at *2. (Please see page 1 above for a discussion of the most recent jurisprudence applying *Morrison*.)

Merck v. Reynolds

In the only other Supreme Court decision to address securities fraud actions in 2010, *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784 (2010), the Court issued guidance on when a private securities fraud action is considered timely. The applicable statute holds that private securities fraud suits must be filed within the earlier of "2 years after the discovery of the facts constituting the violation" or "5 years after such violation." 28 U.S.C. § 1658(b). "Construing this limitations statute for the first time," the Court held that a private securities fraud cause "accrues (1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered 'the facts constituting the violation,'—whichever comes first." *Id.* at 1789-90.

Under the *Merck* ruling, discovery of a misleading statement or omission, standing alone, is not sufficient to put a potential plaintiff on notice for purposes of the statute of limitations. Rather, "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,' including scienter." *Id.* at 1798; *see also id.* at 1796 (holding that "facts showing scienter are among those that 'constitut[e] the violation.'").

The Court explained that "[a] plaintiff cannot recover [under Section 10(b)] without proving that a defendant made a material misstatement *with an intent to deceive*—not merely innocently or negligently." *Id.* at 1796. "[I]f the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter," the Court reasoned that "[i]t would … frustrate the very purpose of the discovery rule" in the statute of limitations. *Id.* A defendant would be able to escape liability by "conceal[ing] for two years that he made a misstatement with an intent to deceive." *Id.*

Notably, the Court found that a cause of action does not necessarily begin to accrue when the plaintiff is on "inquiry notice" or receives a "storm warning." The Court clarified that while "terms such as 'inquiry notice' and 'storm warnings' may be useful to the extent that they identify a time when the facts would have prompted a reasonable plaintiff to begin investigating," the statute of limitations "does not begin to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation,' including scienter." *Id.* at 1798.

The ramifications of the *Merck* decision remain to be seen. While most securities fraud actions are filed on the heels of a corrective disclosure or a government investigation into alleged misstatements or omissions, the *Merck* ruling leaves open the possibility in certain circumstances for plaintiffs to bring securities fraud actions based on conduct that occurred more than two years ago.

Pacific Investment Management Co. ("PIMCO") v. Mayer Brown LLP; Affco Investments 2001, L.L.C. v. Proskauer Rose L.L.P.

Presently pending before the Supreme Court is the question of whether secondary actors can be held liable under Section 10(b) for statements that were not directly attributed to them at the time the statements were disseminated. (See pages 11-13, above, for a brief discussion of *Janus Capital Group, Inc. v. First Derivative*

Traders, No. 09-525.) This year, both the Second and Fifth Circuits adopted a bright-line attribution rule for secondary actor liability.

In *PIMCO v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010), the Second Circuit addressed the question of whether a corporation's outside counsel can be liable under Section 10(b) for "false statements that those attorneys allegedly create[d], but which were not attributed to the law firm or its attorneys at the time the statements were disseminated." *Id*. at 148. The Second Circuit rejected the argument—advanced by the SEC and the plaintiffs—that "a defendant can be liable for creating a false statement that investors rely on, regardless of whether that statement is attributed to the defendant at the time of dissemination." *Id*. at 151. Instead, the Second Circuit reaffirmed the validity of the bright-line attribution rule previously articulated in *Wright v. Ernst & Young*, 152 F.3d 169, 175 (2d Cir. 1998): "[S]econdary actors can be liable in a private action under Rule 10b-5 for only those statements that are explicitly attributed to them." *PIMCO*, 603 F.3d at 155. Under the *PIMCO* holding, "[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" to give rise to Section 10(b) liability. *Id*.

The Fifth Circuit arrived at the same conclusion a few months later. *See Affco Investments 2001, L.L.C. v. Proskauer Rose, L.L.P.*, 625 F.3d 185 (5th Cir. 2010). In *Affco*, the court considered whether a law firm could face Section 10(b) liability for "behind the scenes" preparation of "model opinions supporting the validity of [a] tax scheme" in which the plaintiffs invested. *Id*. at 188. The Fifth Circuit determined that "[w]ithout direct attribution to [the law firm] of its role in the tax scheme, reliance on [the law firm's] participation in the scheme is too indirect for liability." *Id*. at 192. In reaching this decision, the *Affco* court found that the Supreme Court's ruling in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) "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*, 625 F.3d at 194.

As the Supreme Court in *Janus* considers the question of whether attribution is required for secondary actor liability, the decisions of the Second and Fifth Circuits this past year may persuade the Court to adopt a bright-line rule requiring direct, contemporaneous attribution for secondary actor liability to attach.

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