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This month's Alert addresses the oral argument before the Supreme Court in *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds* (No. 11-1085), a case in which the Court is considering whether plaintiffs must establish materiality to win class certification under the fraud-on-the-market theory of reliance.

We also discuss a Southern District of New York decision finding allegations of internal control-related misrepresentations sufficient to state a Section 10(b) claim on a stand-alone basis; as well as a Western District of Texas decision holding that the SEC may bring a claim to claw back executive bonus and incentive compensation under Section 304 of the Sarbanes-Oxley Act without alleging misconduct or scienter.

Finally, we address a Southern District of Ohio decision holding that a "no reliance" clause precludes a sophisticated investor from bringing fraud and negligent misrepresentation claims against Credit Suisse Securities.

# The Supreme Court Hears Oral Argument in *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds*

On November 5, 2012, the Supreme Court heard oral argument in *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds* (No. 11-1085). At issue is "[w]hether, in a misrepresentation case under SEC Rule 10b-5, [a] district court must require proof of materiality before certifying a plaintiff class based on the fraud-on-the-market theory" set forth in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (Blackmun, J.).[1] Questions Presented. The Court is also considering whether courts "must allow [a] defendant to present evidence rebutting the applicability of the fraud-on-the-market theory before certifying a plaintiff class based on that theory." *Id.*

1. In *Basic*, the Court stated that "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations … may be presumed for purposes of a Rule 10b-5 action." 485 U.S. at 247.

## Background

In *Connecticut Retirement Plans and Trust Funds v. Amgen Inc.*, 660 F.3d 1170 (9th Cir. 2011) (Silverman, J.), the Ninth Circuit upheld an order granting class certification in a securities fraud suit concerning alleged misstatements regarding two Amgen pharmaceuticals. The Ninth Circuit ruled that "plaintiffs need not *prove* materiality to avail

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themselves of the fraud-on-the-market presumption of reliance at the class certification stage." *Amgen*, 660 F.3d at 1177.

Amgen petitioned the Supreme Court for certiorari, arguing that the Ninth Circuit's decision had widened a circuit split on the question of whether proof of materiality is required for class certification. Amgen stated that the Second and Fifth Circuits require plaintiffs to prove materiality at the class certification stage, while the Seventh Circuit prohibits courts from considering materiality for class certification purposes.[2] Amgen also noted that the Third Circuit has adopted an intermediate approach, holding that plaintiffs need not establish materiality as part of an initial showing for class certification purposes, but permitting defendants to rebut the applicability of the fraud-on-the-market theory by disproving the materiality of the alleged misrepresentation.[3] Amgen emphasized the "immense settlement pressure generated by class certification orders in securities fraud litigation" and contended that "[a] rule that postpones consideration of materiality until summary judgment or trial effectively means that, in most cases, there will be no examination of materiality—at any stage of litigation." Petition for a Writ of Certiorari at 15.

On June 12, 2012, the Supreme Court granted certiorari to review the Ninth Circuit's decision. (Please click here to read our discussion of the certiorari-level briefings in the June 2012 edition of the Alert.)

## Amgen Argues That Courts Must Consider Materiality First at the Class Certification Stage and Then Again at the Merits Stage

During oral argument, counsel for Amgen stated that "[t]he real question in this case is what is the purpose of Rule 23."[4] Transcript at 12. What must a class representative "show to get through the certification gate to transform an ordinary bilateral dispute" into "something entirely different, a class of tens or hundreds of thousands of people, all of whom are proceeding together?" *Id.* at 20. "If you think that the purpose of Rule 23 is to postpone to the merits everything that can be postponed without a risk of foreclosing valid individual claims, we lose." *Id.* at 12. But Amgen posited that this is "not the purpose" of Rule 23. *Id.* "The purpose is for a court to determine whether all of the preconditions for forcing everyone into a class action are present before you certify." *Id.*

Amgen argued that plaintiffs must prove materiality to benefit from the fraud-on-the-market theory of reliance at the class certification stage, but suggested that the trial court's determination of materiality at the certification stage would not necessarily be "binding on the trier-of-fact" at a later stage of the litigation. *Id.* at 6. Amgen stated that "the

2. *See* Petition for a Writ of Certiorari at 9-12 (comparing *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 481 (2d Cir. 2008) (Pooler, J.) and *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 265 (5th Cir. 2007) (Higginbotham, J.), *abrogated on other grounds by Erica P. John Fund*, 131 S. Ct. 2179 (2011) (Roberts, C.J.) with *Schleicher v. Wendt*, 618 F.3d 679, 685 (7th Cir. 2010) (Easterbrook, C.J.)).

3. *See id.* at 11 (citing *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 631 (3d Cir. 2011) (Scirica, J.)).

4. Rule 23 provides in relevant part that "a class action may be maintained" if "the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members." Fed. R. Civ. P. 23(b)(3).

inability to prove to a certifying judge that … class-wide reliance exists because the statement was material doesn't preclude a plaintiff" from later bringing a securities fraud suit based on that plaintiff's direct reliance on the statement at issue. *Id*. at 5.

Justice Kagan took issue with Amgen's claim that "a plaintiff can always relitigate the question of materiality." *Id*. at 6. She stated that "at the class certification stage, isn't it correct that if the [c]ourt holds that a statement is immaterial, it's immaterial for all members of the class, and the suit has to be dismissed?" *Id*. Justice Ginsburg later echoed this same sentiment, stating that "I am really nonplussed by [Amgen's] answer that if the judge says it's immaterial, that doesn't end it for everybody.… [I]f it's immaterial, the case ends. And if it is material, then it is material to everybody in the class." *Id*. at 10.

Justice Breyer observed that Amgen was essentially claiming that a statement "could still be material for some individual, even though there is no market reliance." *Id*. at 13. He questioned the premise underlying this line of reasoning: "we could always think of a few examples where, despite the fact that, you know, that it's only a common issue 99 percent of the time, we can dream up a situation where it's not a common issue." *Id*.

Justice Kagan emphasized that the question of class certification "is a question of coherence; it's a question of whether the class wins or loses together." *Id*. at 14. She noted that under the test set forth in *Wal-Mart Stores, Inc. v. Dukes*, 131 S.Ct. 2541 (2011) (Scalia, J.),[5] materiality is a question for which the court can "rule on each of the claims in one stroke." *Id*. at 15. Justice Ginsburg agreed: "I just don't understand why this isn't just a clear case of a question common to the class; that is, the question of materiality." *Id*. at 16.

Counsel for Amgen responded that "there is class cohesion" only if "the alleged misinformation was significant enough to affect the price, thus enabling the common claim of relying on the misinformation in the same way." *Id*. at 15-16. "The statement has to be material because immaterial statements don't move markets." *Id*. at 20. "Letting a putative representative through the certification gate without showing that key is like … no harm, no foul, because [the plaintiffs] will all lose together." *Id*. at 16.

Justice Ginsburg noted that Amgen "seem[ed] to be setting out two determinations of materiality." *Id*. at 21. She stated:

> You say in order to certify the class you have to show that the misrepresentation was material. And in order to win on the merits, you certainly have to show that the misrepresentation was material.… How does the finding that you say must be made at the certification stage differ from the finding that must be made at the trial?

*Id*. Amgen stated that "[t]hey differ temporally, they differ functionally, and they differ in terms of who decides it and with what level of finality." *Id*. Justice Ginsburg followed up by observing that "it's the same question" and asked: "[I]f it's established at the certification stage, it has to be established again at trial?" *Id*. at 22. Amgen answered: "That's correct. Just like the market efficiency and the public statement and

5. The *Dukes* Court stated that "[w]hat matters to class certification … is not the raising of common 'questions'—even in droves—but rather the capacity of a classwide proceeding to generate common answers apt to drive the resolution of the litigation." 131 S. Ct. at 2551 (quoting Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. Rev. 97, 132 (2009)).

the market timing. Every one of those predicates has to be proven to the jury's satisfaction at trial." *Id.*

## Connecticut Retirement Plans and Trust Funds Contends That Materiality Is a "Quintessential" Common Question That Should Be Considered Only at the Merits Stage

Justice Ginsburg questioned why defendants should not be permitted to rebut materiality and thus challenge the applicability of the fraud-on-the-market theory at the class certification stage. Counsel for the plaintiff-respondent Connecticut Retirement Plans and Trust Funds ("Connecticut Retirement") answered that "*Basic* needs to be read against the backdrop of Rule 23, and especially this Court's recent decision in *Wal-Mart v. Dukes*." *Id.* at 24. "Because materiality always generates a common answer for all class members, it is the quintessential common issue that does not splinter the class or cause it to be noncohesive for purposes of understanding predominance." *Id.* "If the market is efficient and it is absorbing information into the price, all investors will have the same question with respect to materiality." *Id.* at 26. "They all lose on the merits if there is no materiality." *Id.* Connecticut Retirement argued that "[w]ith materiality, it is a common element of the tort always … so there is no special reason to or desirability in or need for litigating at the outset." *Id.* at 33-34.

Justice Scalia rejoined that "there is a reason for deciding it earlier, and the reason is the … enormous pressure to settle once the class is certified." *Id.* at 34. "In most cases, that's the end of the lawsuit … there's automatically a settlement." *Id.* Justice Scalia noted that "one of way of … certifying the class is to show … it's an efficient market and you can presume that everybody in the class relied on the market." *Id.* But this presumption is "only true" if "the statement was material to the market." *Id.* "If it was immaterial to the market, that isn't true. And you should not proceed any further, and you should not begin [a] … class action which, in most cases, is simply the preliminary to a settlement." *Id.*

Connecticut Retirement answered that this approach "would consign district court judges to having many trials on the merits because … materiality is such a highly contextual inquiry." *Id.* at 35. In response, Justice Kennedy pointed out courts "have the burden of justifying class certification." *Id.*

## The United States, as Amicus Curiae, Argues That Materiality Should Only Be Litigated Once and Emphasizes That Class Certification Is Not a Merits Determination

Counsel for the United States, advocating in support of the respondents' position, stated that "the confusion here is that materiality in a fraud-on-the-market case serves two purposes: It is a predicate to the fraud-on-the-market theory, but it is also an independent, separate element." *Id.* at 40. "[W]hat [Amgen] would have this Court do is isolate the two inquiries when they're really the same question." *Id.* "It is asking the same question that leads to the same answer, and it's one that unites the class." *Id.*

Justice Scalia stated that "[i]f you have the same question, then maybe we shouldn't have this fraud-

on-the-market theory." *Id*. at 41. "[M]aybe we should overrule *Basic* because it was certainly based upon a theory that … simply collapses once you remove the materiality element." *Id*. Justice Kennedy observed that "24 years of economic scholarship" since Basic was decided "has shown that the efficient market theory is … really an overgeneralization." *Id*. at 42.

Counsel for the United States emphasized that "the problem with [Amgen's] position is that it would require relitigation of the materiality question at the merits stage to the extent the class is certified." *Id*. at 46. Moreover, counsel for the United States explained that "class certification is not about only certifying meritorious cases." *Id*. at 47. "In the current rule of Rule 23(b)(3), you want to certify class actions that are both meritorious and those that are not, so it reaches a binding judgment." *Id*.

* * *

The Supreme Court is expected to issue a decision in *Amgen* later this term. We will report on the Court's ruling in a future edition of the Alert.

# The Southern District of New York Finds Alleged Misrepresentations About Internal Controls Sufficient on a Stand-Alone Basis to State a Securities Fraud Claim

On November 7, 2012, the Southern District of New York declined to dismiss securities fraud claims concerning alleged misrepresentations regarding Weatherford International Ltd.'s internal controls, even though the court found that the plaintiffs had failed to state a claim as to the tax understatement that resulted from Weatherford's internal control failures. *Dobina v. Weatherford Int'l Ltd.*, 2012 WL 5458148 (S.D.N.Y. Nov. 7, 2012) (Kaplan, J.).

## Background

"Weatherford is an 'international provider of equipment and services used in the drilling, completion and production of oil and natural gas wells.'" *Id*. at *1. Beginning in 2007, Weatherford reported "'low and rapidly declining effective tax rates'" which were among "'the lowest, if not the lowest, in the industry.'" *Id*. However, on March 1, 2011, Weatherford "announced that it would restate its earnings for 2007 through the third quarter of 2010." *Id*. at *2. The company disclosed that it had identified a "'material weakness in internal control over financial reporting for income taxes'" and that its 2007-2010 tax expense was actually $1.2 billion rather than the previously reported $700 million. *Id*. at *2. The following day, the company's stock price declined nearly 11 percent. *Id*.

Plaintiffs subsequently brought suit against Weatherford, certain of its officers, and the company's auditor under Sections 10(b) and 20(a) of the Exchange Act, as well as Rule 10b-5. The plaintiffs alleged that the Weatherford defendants had "committed securities fraud through false statements and omissions falling into two principal categories: (1) those arising directly from the understatement of tax expense and (2) those pertaining to Weatherford's maintenance of internal controls over its financial reporting." *Id*.

## The Court Finds an Interest in Corporate Stock-Funded Acquisitions Insufficient to Allege Motive to Commit Securities Fraud

"A complaint may satisfy the *scienter* requirement 'by alleging facts to show either (1) that [the] defendants had the motive and opportunity to commit the fraud, or (2) strong circumstantial evidence of conscious misbehavior or recklessness.'" *Id*. at *3 (quoting *ECA & Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 198 (2d Cir. 2009) (Kelly Jr., J.)).

The plaintiffs' motive allegations were based

on their "theory that the fraud [had] inflated Weatherford's stock price and thus permitted it to fund its 'aggressive growth strategy' while avoiding becoming an acquisition target in its own right." *Id.* at *4. The plaintiffs pointed to a series of stock-funded Weatherford acquisitions during the class period as support for this theory.

With respect to the individual defendants, the court found that this theory was "rejected easily" because there was no allegation that the defendants had engaged in stock-funded acquisition transactions "'to secure personal gain' as opposed to carrying out their 'financial responsibilities to the [c]ompany.'" *Id.* at *5. However, the court found "[m]ore challenging … the question of whether the corporate defendant—Weatherford itself—may be inferred to have had the requisite motive due to its interest in acquiring other companies." *Id.*

The court explained that "[w]hether an interest in acquisitions is sufficient [for alleging scienter] is an 'extremely contextual' inquiry that demands an allegation of a 'unique connection between the fraud and the acquisition.'" *Id.* (quoting *ECA*, 553 F.3d at 201 n. 6). The Second Circuit "has provided little guidance as to what this 'unique connection' must be, but has suggested that it is sufficient when the 'misstatements directly relat[e] to the acquisition.'" *Id.* (quoting *ECA*, 553 F.3d at 201 n. 6). The court concluded that this requirement "demands more than alleging simply that [Weatherford] [had] acquired companies during the class period with the use of stock." *Id.*

The court emphasized the need "to apply exacting scrutiny to any claim of motive through company acquisitions." *Id.* "[W]hile an acquisition program funded by stock issuances in a certain sense might provide a 'motive' to inflate the stock price, it is not sufficient to allege *scienter*." *Id.* at *6. Holding otherwise "would allow a plaintiff to proceed to discovery whenever it can allege that a company that is growing through the issuance of equity made a statement that ultimately proved to have been materially false but helped to raise the company's share price." *Id.* Such

a result would be "inconsistent with the [Private Securities Litigation Reform Act (PSLRA)] and [the Second] Circuit's requirements of a 'unique connection' between the fraud and the acquisition."" *Id.* The court therefore found that plaintiffs had not adequately alleged motive as to Weatherford based on its interest in stock-funded acquisitions.

## The Court Finds the Complaint Adequately Alleges Scienter as to the Statements Concerning Internal Controls

The court next considered whether the complaint adequately alleged that certain defendants had "made statements regarding the effectiveness of Weatherford's internal controls … either knowing that they were false or with reckless disregard for their truth." *Id.* at *6-7.

Weatherford's CEO, Bernard Duroc-Danner, and the company's CFO, Andrew Becnel, individually certified that they were "'responsible for establishing and maintaining [the company's] disclosure controls and procedures … and internal controls for financial reporting'" and represented that they had "'[d]esigned such internal control over financial reporting … to provide reasonable assurance regarding the reliability of [Weatherford's] financial reporting.'" *Id.* at *6. Duroc-

Danner and Becnel continued to make attestations regarding the effectiveness of the company's internal controls as late as November 1, 2010.

In contrast to these representations, Weatherford's "March 2011 restatement … detailed significant gaps in [the company's] internal controls." *Id.* "Although the March 2011 restatement specifically stated only that Weatherford's internal control over financial reporting … was not effective 'as of December 31, 2010,'" the court found it reasonable to infer that "Weatherford's internal controls in fact were inadequate throughout the class period" in view of "the [c]ompany's attestations through the class period that its internal controls had not changed and the fact that the $500 million tax expense understatement persisted from 2007 through 2010." *Id.* at *7.

Turning to the question of scienter, the court acknowledged that the certifications at issue "involve[d] a certain amount of subjectivity, e.g., regarding whether Weatherford's internal controls provide[d] reasonable assurance about the reliability of financial reporting." *Id.* (internal quotations omitted). However, the court explained that "subjectivity will not completely immunize a statement from review under Section 10(b)." *Id.* "Indeed, a plaintiff can plead a claim adequately based even on a statement of opinion if it alleges facts sufficient to 'permit a conclusion that [the defendant] either did not in fact hold that opinion or knew that it had no reasonable basis for it.'" *Id.* (quoting *In re Lehman Bros. Sec. and ERISA Litig.*, 799 F. Supp. 2d 258, 302 (S.D.N.Y. 2011) (Kaplan, J.)).

The court concluded that the plaintiffs had "alleged *scienter* adequately with regard to Becnel's statements about internal controls" based, among other factors, on "the personal participation of Becnel in designing and evaluating [Weatherford's] internal controls" and "the stark realities about the inadequacies of the internal controls that were revealed in the March 2011 restatement." *Id.* at *7, *9. The restatement "admitted inadequate staffing and technical expertise, ineffective review and approval practices, inadequate processes to effectively reconcile income tax accounts and inadequate controls over the preparation of quarterly tax provisions." *Id.* at *7 (internal quotations omitted). "Given Becnel's personal participation in designing and evaluating the internal controls," the court found that "he presumably had extensive knowledge about precisely these matters." *Id.* Thus, the court held that "[t]he inference that his certifications were made with reckless disregard for the truth is at least as compelling as any opposing, nonculpable inference." *Id.* at *7, *9.

The court also found the complaint "adequately alleges *scienter* with regard to Weatherford." *Id.* at *9. However, the court determined that the complaint "does not sufficiently allege scienter with respect to any of the other individual defendants." *Id.* Specifically, the court found the complaint's scienter allegations "insufficient … with respect to Duroc-Danner because it fails to allege that he was aware of any issues with internal controls at all during the class period." *Id.*

## The Court Finds No Basis for Inferring Scienter as to Weatherford's Tax Understatement

The court next considered the plaintiffs' allegations of an "'international scheme whereby defendants 'crudely manipulated the [c]ompany's effective tax rate expense by a few percentage points each quarter and fiscal year to generate enough earnings to meet or beat the [c]ompany's targets in key periods.'" *Id.* The court found the complaint "entirely devoid of factual allegations that could make plausible, let alone compelling, the inference that [the] defendants actively manipulated the tax receivable asset in order to beat Wall Street estimates or otherwise inflate earnings by a desired amount." *Id.*

Notably, the court held that the defendants' alleged misstatements concerning internal controls did not support an inference of scienter as to Weatherford's

tax understatement. "While Weatherford's poor internal controls may give rise to liability with respect to the defendants' statements *about* internal controls, the weak internal controls provide little if any circumstantial support that the statements [regarding the] understated tax expense were made with *scienter*." *Id*. at *10. "Simply put, '[w]eak accounting controls may pave the way for fraud. They do not themselves constitute fraud.'" *Id*. (quoting *In re BISYS Sec. Litig*., 397 F. Supp. 2d 430, 450 (S.D.N.Y. 2005) (Kaplan, J.)).

This left the plaintiffs' "central points—that the magnitude of the understatement and the defendants' and investors' considerable focus on Weatherford's tax rates demonstrate[d] that the defendants were at least reckless with regard to the truth of their statements." *Id*. The court quickly disposed of both arguments, explaining that "'the size of the fraud alone does not create an inference of scienter'" and noting the absence of any allegation that "the Weatherford defendants had any contemporaneous basis to believe that the information they related was incorrect." *Id*. at *11.

Here, the court found it plausible that "management's statements about the [c]ompany's tax expense were the result of merely careless mistakes at the management level based on false information fed it from below." *Id*. (internal quotations omitted). Thus, the court held that the complaint "fails adequately to allege scienter with regard to the understatement of tax expense." *Id*.

## The Western District of Texas Holds That the SEC May Claw Back Executive Bonus and Incentive Compensation under Section 304 of the Sarbanes-Oxley Act Without a Showing of Misconduct or Scienter

Section 304 of the Sarbanes-Oxley Act "establishes that the SEC may sue the CEO and CFO of a company" for reimbursement of bonus and incentive compensation "when the company has been required to restate its earnings due to noncompliance with securities laws."[6] *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust ex rel. Fed. Nat'l Mortg. Ass'n v. Raines*, 534 F.3d 779, 793 (D.C. Cir. 2008) (Kavanaugh, J.).

On November 13, 2012, the Western District of Texas held that the SEC may state a claim under Section 304 without alleging that the executives "committed any conscious wrongdoing." *SEC v. Baker*, 2012 WL 5499497, at *1 (W.D. Tex. Nov. 13, 2012) (Sparks, J.). The court also rejected constitutionality challenges to Section 304. The court reasoned that "[i]n enacting § 304 of Sarbanes-Oxley, Congress determined to put a modest measure of real risk back into the [compensation] equation" for corporate officers. *Id*. at

6. Section 304 of the Sarbanes-Oxley Act is entitled "Forfeiture of certain bonuses and profits" and provides in relevant part as follows:

> If an issuer is required to provide an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the [CEO] and [CFO] shall reimburse the issuer for—(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the [SEC] (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.

15 U.S.C. § 7243(a) (2012).

*11. "Section 304 creates a powerful incentive for CEOs and CFOs to take their corporate responsibilities very seriously indeed." *Id.*

## Background

On July 21, 2008, ArthroCare Corporation restated its financial statements for 2006, 2007, and the quarter ending March 31, 2008 as a result of "alleged fraud by two senior vice presidents of Arthrocare, John Raffle and David Applegate." *Id.* at *1. The SEC subsequently brought suit under Section 304 of the Sarbanes-Oxley Act seeking "statutory reimbursement—on behalf of Arthro[C]are—of cash bonuses, incentives, and equity-based compensation" earned by ArthroCare's CEO, Michael A. Baker, and its CFO, Michael T. Gluk, during the periods affected by the restatements. *Id.*

The SEC did not allege that Baker and Gluk had "committed any conscious wrongdoing." *Id.* Instead, the SEC asserted that the defendants were "required to reimburse Arthro[C]are simply because they were the CEO and CFO at the time (and thus signed the filings which subsequently required restatements)." *Id.* Baker and Gluk moved to dismiss the SEC's claims on the grounds that "§ 304 either cannot be construed … to impose liability on CEOs and CFOs without any element of scienter, or, alternatively, because § 304 is unconstitutional." *Id.* The defendants "also raise[d] a statutory defense in the form of the Civil Asset Forfeiture Reform Act." *Id.*

## The Court Finds Section 304 Does Not Require Scienter or Misconduct

The defendants contended that Section 304 should be construed "(1) to require misconduct by the corporate officer himself, (2) to define 'misconduct' as an independent violation of securities law, [or] (3) as only providing a remedy for the SEC when an officer engages in misconduct which is itself a violation of another securities law." *Id.* at *4. The court rejected these claims, finding that "[t]he text of the statute plainly contains no such additional requirements." *Id.* at *5. "Rather," the court held that "the statute unambiguously requires CEOs and CFOs to reimburse the issuer for any qualifying compensation they receive within one year of a filing which the issuer is subsequently forced to restate due to misconduct by the issuer or its agents." *Id.*

The court noted that "[t]he handful of cases which have had occasion to describe the import of § 304 are likewise devoid of any mention of a scienter requirement." *Id.* For example, in *SEC v. Jenkins*, 718 F. Supp. 2d 1070, 1072 (D. Ariz. 2010) (Snow, J.), the court "persuasively rejected similar attempts by the officer defendant to read into the statute a requirement of misconduct by the officer." *Baker*, 2012 WL 5499497, at *4.

The *Jenkins* court held that "the text and structure of Section 304 require only the misconduct of the issuer, but do not necessarily require the specific misconduct of the issuer's CEO or CFO." *Jenkins*, 718 F. Supp. 2d at 1074. The court explained that "it was Congress's purpose to recapture the additional compensation paid to a CEO during any period in which the corporate issuer was not in compliance with financial reporting requirements." *Id.* at 1075. "A CEO need not

be personally aware of financial misconduct to have received additional compensation during the period of that misconduct, and to have unfairly benefitted therefrom." *Id*. The *Jenkins* court found that "[i]t is not irrational for Congress to require that such additional compensation amounts be repaid to the issuer." *Id*.

The *Baker* court explained that while "it might be surprising at first glance to require CEOs and CFOs to reimburse their employers when they have not done anything illegal, there are good policy reasons why Congress may have provided for the broad scope of § 304 suggested by the SEC." *Baker*, 2012 WL 5499497, at *5. "Imagine if someone told you that they would take away half of everything you earned this year if you did not catch the misconduct of one of your employees." *Id*. (quoting Alison List, Note, *The Lax Enforcement of Section 304 of Sarbanes–Oxley: Why is the SEC Ignoring its Greatest Asset in the Fight Against Corporate Misconduct?*, 70 OHIO ST. L.J. 195, 216 (2009)). "You would most likely be highly motivated to catch the misconduct." *Id*. (internal quotations omitted). This is why Sarbanes-Oxley "includes provisions designed to prevent CEOs or CFOs from making large profits by selling company stock, or receiving company bonuses, while *management* is misleading the public and regulators about the poor health of the company." *Id*. at *6 (quoting S. REP. NO. 107-205, 2002 WL 1443523, at *23 (2002) (emphasis added by the court).

Here, the defendants had "received generous compensation, while two managers, Raffle and Applegate, were misleading the public about Arthro[C]are's financial condition." *Id*. The court noted that "[i]f legislative history is any indication, Congress had facts similar to this case squarely in mind in enacting" Sarbanes-Oxley. *Id*.

The *Baker* court also reasoned that "limit[ing] the scope of § 304 as Baker and Gluk suggest would render it a meaningless act on the part of Congress, because the SEC's power to seek equitable disgorgement of profits gained through wrongdoing pre-dates Sarbanes-Oxley by many years." *Id*. "In addition, various other securities laws penalize active wrongdoing, either on the basis of intentional, knowing, or negligent acts or omissions." *Id*. "By requiring reimbursement, even in the absence of any wrongdoing, Congress was logically extending and expanding the regulatory scheme for publicly traded securities in reaction to the various accounting scandals which triggered Sarbanes-Oxley." *Id*.

## The Court Holds Section 304 Is Not an Equitable Disgorgement Provision

The defendants argued that "§ 304 should be construed as some type of statutory disgorgement provision, equivalent to the long-standing common-law doctrine of equitable disgorgement" and should therefore be "generally limited to cases in which the officers themselves have engaged in wrongdoing." *Id*. at *7. In support of this claim, the defendants pointed to case law from the Ninth Circuit holding that "the reimbursement provision of [Section] 304 is considered an equitable disgorgement remedy and not a legal penalty." *SEC v. Jasper*, 678 F.3d 1116, 1130 (9th Cir. 2012) (Bea, J.) (relying on *In re Digimarc Corp. Derivative Litig.*, 549 F.3d 1223, 1232-33 (9th Cir. 2008) (Bybee, J.)).

Rejecting the defendants' contention, the *Baker* court held that "§ 304 is not equivalent to equitable disgorgement." *Baker*, 2012 WL 5499497, at *8. The court explained that the defendants' argument "cannot be harmonized with the language of § 304, which is devoid of any necessary link between the acts of the CEO or CFO, and the compensation which is subject to reimbursement." *Id*. at *7. As to the Ninth Circuit cases on which the defendants relied, the *Baker* court explained that neither case "address[ed] whether … § 304 reimbursement [is limited] to profits attributable to wrongdoing." *Id*. The court also noted that it was not bound by the Ninth Circuit's rulings in any event. *Id*. Finally, the *Baker* court observed that at least one other court to consider the issue has held that "§ 304 reimbursement is a penalty, not a

disgorgement." *Id.* at *8 (citing *SEC v. Microtune*, 783 F. Supp. 2d 867, 886-87 (N.D. Tex. 2011) (Boyle, J.)).

## The Court Rejects the Defendants' Constitutionality Challenges to Section 304

Turning to the defendants' constitutionality challenges, the *Baker* court found Section 304 "constitutional on its face." *Id.* The court explained that "only rational basis review applies" to Section 304 because the defendants are not "members of any protected class," nor had they "otherwise shown fundamental rights are at stake, requiring a heightened level of scrutiny." *Id.* The court determined that "there is a rational basis for § 304: it creates a personal incentive for CEOs and CFOs to take their reporting and certification duties seriously." *Id.*

The defendants argued that "it is unclear *whose* misconduct will trigger reimbursement" under Section 304. *Id.* The court disagreed, explaining that "the 'misconduct' in question is misconduct by the issuer … [and] its agents." *Id.* "As a practical matter," the court found that "the 'who' will also no doubt be limited to those agents of the issuer who are in sufficiently high-ranking positions as to be able to cause 'material noncompliance … with any financial reporting requirement under the securities laws.'" *Id.* (quoting 15 U.S.C. § 7243(a) (2012)).

The defendants further claimed that "§ 304 is vague because it does not clearly state when or why liability will be imposed." *Id.* at *9. The court found that "§ 304's requirements upon CEOs and CFOs are crystal clear, when read in conjunction with the rest of Sarbanes-Oxley." *Id.* "Section 302 of the Act tells executives precisely what they must do to avoid reimbursement liability under § 304: they must ensure the issuer files accurate financial statements." *Id.* "And it tells them how they are to go about doing so, such as by: 'establishing and maintaining internal controls.'" *Id.* (quoting 15 U.S.C. § 7241(a)(4)(A) (2012)).

With respect to the defendants' assertion that § 304 violates the Excessive Fines Clause of the Eighth Amendment, the court found this clause "inapplicable" because "§ 304 only requires reimbursement to the issuer: no money is forfeited to the government." *Id.* The court further determined that Section 304 "falls outside of the scope of the Excessive Fines Clause" because it is "at least partly remedial in nature." *Id.*

The court also rejected the defendants' claim that "§ 304 violates the Due Process Clause by not requiring any reasonable relationship between the triggering conduct and the penalty imposed on an otherwise innocent person." *Id.* "[B]y signing SEC filings, corporate officers are making solemn guarantees that they have carefully reviewed the filings for accuracy, and that such accuracy is underwritten by adequate controls." *Id.* "When, as here, those controls prove inadequate, and corporate officers are asleep on their watch, it is reasonable for Congress to impose a penalty." *Id.* "The degree of penalty is reasonable too: it is limited to bonuses, incentive-based pay, and stock-sales profits." *Id.* "Furthermore, Congress provided a safety valve, namely the SEC's power to exempt corporate officers when appropriate." *Id.*

In addition, the court found no basis for the

defendants' argument that "§ 304 fails to provide fair notice." *Id*. at *10. The court explained that "Sarbanes-Oxley as a whole provides ample notice of what conduct is required." *Id*.

## The Court Finds That CAFRA Does Not Apply to § 304

Lastly, the defendants argued that "the Civil Asset Forfeiture Reform Act (CAFRA) independently bars a § 304 action against 'innocent' officers such as themselves." *Id*. at *4. CAFRA provides that "an innocent owner's interest in property shall not be forfeited under any civil forfeiture statute." 18 U.S.C. § 983(d)(1) (2012).

The court determined that "CAFRA is inapplicable to an action under § 304." *Baker*, 2012 WL 5499497, at *10. "First and foremost, the Supreme Court has explained that civil forfeiture actions are *in rem* proceedings, … whereas § 304 plainly creates an *in personam* cause of action." *Id*. (citing *United States v. Ursery*, 518 U.S. 267, 275 (1996) (Rehnquist, C.J.)). "[A] § 304 action has nothing to do with property being put to an illegal purpose; rather, it is directed at failure to comply with securities filing requirements." *Id*. Moreover, if CAFRA "applie[d] to § 304 proceedings, then it would follow [that] Congress chose to enact a meaningless statute in § 304, because recovery of compensation from CEOs and CFOs who are not 'innocent owners' is already provided for by various other provisions of the Sarbanes-Oxley Act and the Securities and Exchange Act." *Id*. at *11. "Of course, Congress is … presumed to *not* engage in meaningless acts." *Id*. The court therefore held that "Congress must have assumed and intended CAFRA would have no application to § 304." *Id*.

# The Southern District of Ohio Holds That a "No Reliance" Clause Precludes Fraud and Negligent Misrepresentation Claims Brought by a Sophisticated Investor against Credit Suisse

On October 26, 2012, the Southern District of Ohio granted summary judgment in favor of Credit Suisse Securities LLC in a fraud suit brought by Pharos Capital Partners, L.P. in connection with Pharos's "failed $12 million equity investment" in National Century Financial Enterprises, Inc. ("NCFE" or "National Century"). *Pharos Capital Partners, L.P v. Deloitte & Touche, L.L.P. (In re National Century Financial Enterprises, Inc. Investment Litigation)*, 2012 WL 5334027, at *1 (S.D. Oh. Oct. 26, 2012) (Graham, J.). The court held "as a matter of law that Pharos could not have justifiably relied on [any] alleged misrepresentations and omissions made by Credit Suisse" because the parties had "entered into a Letter Agreement in which Pharos acknowledged that it was 'a sophisticated institutional investor' who was 'relying exclusively' on its own due diligence investigation and who would bear the risk of 'an entire loss' of its investment." *Id*. The court's decision did not address the federal securities laws.

## Background

"Pharos is a limited partnership that makes private equity investments for its limited partner investors." *Id*. In February 2002, Pharos contacted Credit Suisse about investment opportunities. At the time, "Credit Suisse was acting as a co-placement agent for National Century in connection with a $190 million private placement of securities." *Id*. Heather Nicolau of Credit Suisse informed Bob

Crants, one of Pharos's managing partners, that Credit Suisse was "'raising equity and mezzanine for … a profitable healthcare receivables company.'" *Id*. at *2. Crants responded that the Pharos team "actually know[s] quite a bit about the healthcare receivables business & would love to take a look." *Id*.

Credit Suisse sent Pharos the private placement memorandum for the NCFE offering, as well as three boxes of due diligence materials, including NCFE's yearly financial audits and the company's unaudited financial data. One of Pharos's managing partners subsequently emailed David Hurwitz of Credit Suisse "asking if the National Century deal was 'all it's cracked up to be.'" *Id*. Hurwitz answered: "I do believe NCFE is what it is cracked up to be. It's extremely profitable and has been for many years. They are the dominant player in the industry and still have great growth opportunities." *Id*.

In March 2002, following a site visit, Pharos informed Credit Suisse that it was "ready to close the deal at quarter's end." *Id*. at *3. However, the deal "did not close as quickly as Pharos had anticipated" because Goldman Sachs, which had been considering serving as lead investor, backed out of the transaction. *Id*. Credit Suisse informed Pharos of this development, and forwarded to Pharos the company's "responses to a series of inquiries Goldman had posed about potential areas of concern," including National Century's history of related party transactions. *Id*. In May 2002, Pharos informed Credit Suisse that it had "'waded through'" Goldman's concerns and determined that it did not "'see a material issue.'" *Id*. at 3.

In June 2002, Credit Suisse emailed Pharos a letter agreement stating that "Pharos was 'relying exclusively' on its own due diligence and would bear the risk of an entire loss and that Credit Suisse had made no representations as to National Century or the credit quality of the securities and had no duty to disclose non-public information to Pharos." *Id*. at *4. Although Pharos's managing directors initially balked at the no-reliance clause, Pharos ultimately signed a letter agreement on July 8, 2002 (the "Letter Agreement") that "retained the language regarding reliance, risk, representations, and disclosure" (the "No Reliance Clause"). *Id*. The No Reliance Clause stated in relevant part as follows:

> "[W]e are a sophisticated institutional investor and have such knowledge and experience in financial and business matters and expertise in assessing credit risk, that we are capable of evaluating the merits, risks and suitability of investing in the [s]ecurities, that we have conducted our own due diligence investigation of the [c]ompany, that we are relying exclusively on our own due diligence investigation and our own sources of information and credit analysis with respect to the [s]ecurities and that we are able to bear the economic risks of … an entire loss of our investment in the [s]ecurities."

*Id*.

On November 18, 2002, Pharos's $12 million investment in National Century "fully lost its value when National Century filed for bankruptcy" as a result of a "massive fraud." *Id*. at *5. In March 2003, Pharos filed suit alleging that "Credit Suisse had knowledge of the material aspects of National Century's fraud and [had] misrepresented to Pharos how National Century ran its operations." *Id*. Pharos "further allege[d] that Credit Suisse should have

disclosed facts about National Century's fraud when Pharos conducted its due diligence investigation." *Id*. Pharos brought claims for fraud, negligent misrepresentation and violations of the Ohio Securities Act. Credit Suisse moved for summary judgment based on the No Reliance Clause.

## The Court Finds Pharos Could Not Have Justifiably Relied on Credit Suisse's Alleged Misrepresentations

"Justifiable reliance is an element of both a fraud and a negligent misrepresentation claim." *Id*. at *7. "In determining whether reliance is justifiable, courts consider such factors as the sophistication of the parties, the nature of their relationship, their access to information, whether the plaintiff initiated the transaction or sought to expedite it, the nature of the alleged misrepresentation, and the content of any agreement they entered into." *Id*.

"After examining [these] factors," the court found "as a matter of law that Pharos [could not] establish justifiable reliance." *Id*. First, "[i]t was Pharos who first approached Credit Suisse, looking for an investment in the healthcare sector." *Id*. Second, the court noted that this was "not a case where Pharos was shielded from adverse information about National Century." *Id*. at *8. For example, "Pharos knew that Goldman Sachs had decided not to serve as lead investor." *Id*. Pharos was also aware that Fitch, Inc. had put certain NCFE notes on a negative ratings watch, and that the company had been late in issuing its audited financial statements for 2001.

Third, the court found that the Letter Agreement "was the product of negotiations between the parties" and its language was "clear." *Id*. The court noted that "[t]he parties referred to the Letter Agreement as a 'big boy' agreement because Pharos in essence said that it knew what it was doing and could take care of itself." *Id*. "To underscore the point, the Agreement stated that Pharos would bear the risk of an 'entire loss' of its investment." *Id*. The court determined that "the clear language of the Letter Agreement and the surrounding factors render[ed] any claimed reliance by Pharos unjustifiable." *Id*. at *9.

The court emphasized that "[t]he case law strongly supports this conclusion in the context of sophisticated parties who have agreed to no-reliance language." *Id*. "To allow Pharos to proceed any further with its fraud and misrepresentation claims would upset the risk allocation the parties bargained for." *Id*. The court pointed to the Seventh Circuit's decision in *Rissmann v. Rissmann*, 213 F.3d 381, 383 (7th Cir. 2000) (Easterbrook, J.). There, the Seventh Circuit explained that "securities transactions would be 'impossibly uncertain' if courts fail[ed] to protect the primacy of written agreements entered into by sophisticated parties." *National Century*, 2012 WL 5334027, at *9 (quoting *Rissmann*, 213 F.3d at 383). The Seventh Circuit "rejected [the] plaintiff's attempt to set aside a no-reliance clause and shift the risk in a way [that] 'could not conceivably have been the outcome of the bargaining.'" *Id*. (quoting *Rissmann*, 213 F.3d at 383). Similarly, the court here found that "Pharos's attempt to shift risk onto Credit Suisse must be rejected." *Id*.

As to Pharos's claim that Credit Suisse "had an independent duty to disclose material information to Pharos because Credit Suisse chose to act as National Century's placement agent," the court explained that

the Letter Agreement "states that Pharos neither needed nor desired any information or advice from Credit Suisse about National Century and that Credit Suisse had no obligation to provide such information." *Id*. at *10. The Letter Agreement further states that "Credit Suisse was not a financial advisor or fiduciary of Pharos." *Id*. The court held that "[t]his unmistakable language defeats any argument Pharos now makes about a duty to disclose and renders unreasonable any expectation Pharos may have had about informational parity." *Id*.

The court also rejected Pharos's claim under New York law that "disclaimers do not preclude a party from claiming reliance on an alleged misrepresentation of a fact that is peculiarly within the other party's knowledge." *Id*. at *11. The court found "[t]his facet of law" to have no application here" because "[t]he peculiar knowledge exception was recognized to protect those parties who have 'no independent means of ascertaining the truth.'" *Id*. (quoting *Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531, 1542 (2d Cir. 1997) (Calabresi, J.)) Here, however, "Pharos had access to boxes of data room materials, conducted extensive due diligence, and communicated directly with National Century's management." *Id*.

Finally, the court found no basis for Pharos's suggestion that it had signed the Letter Agreement under duress. "The factual record at most shows that Credit Suisse exerted financial or business pressures on Pharos" to sign the Letter Agreement. *Id*. The court held that "this does not constitute duress." *Id*. "'A defense of duress cannot be sustained by a contracting party who has simply been bested in contract negotiations by the 'hard bargaining' of another contracting party." *Id*. (quoting *Regent Partners, Inc. v. Parr Dev. Co., Inc.*, 960 F. Supp. 607, 612 (E.D.N.Y. 1997) (Gershon, J.)).

The court held that Credit Suisse was "entitled to summary judgment as to the fraud and misrepresentation claims." *Id*. at *12. The court also granted summary judgment to Credit Suisse with respect to Pharos's claims under the Ohio Securities Act. *Id*. at *17.

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