SIMPSON THACHER

SECURITIES LAW ALERT

NOVEMBER 2013

This month's Alert discusses the Supreme Court's grant of certiorari to reconsider the fraud-on-the-market presumption of reliance adopted in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). We also address two Third Circuit decisions: one holding that the public has a First Amendment right of access to Delaware's government-sponsored arbitration program for business disputes, and another affirming dismissal with prejudice of a securities fraud action against Kid Brands for failure to allege scienter. Finally, we discuss a Southern District of New York decision declining to dismiss a securities fraud action arising out of the collapse of MF Global.

We wish you and yours a wonderful Thanksgiving holiday.

Supreme Court Grants Certiorari to Reconsider the Fraud-on-the-Market Presumption of Reliance Adopted in *Basic Inc. v. Levinson*

On November 15, 2013, the Supreme Court granted certiorari in *Halliburton Co. v. Erica P. John Fund* (13-317) to address two questions. First, the Court will consider whether it "should overrule or substantially modify the holding of *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (Blackmun, J.), to the extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory." Second, the Court will address whether, at the class certification stage, "the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock."

The Fraud-on-the-Market Presumption Adopted in *Basic Inc. v. Levinson*

In *Basic*, the Supreme Court found that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would" prevent securities fraud plaintiffs "from proceeding with a class action, since individual issues" of reliance would "overwhelm[ ] the common ones."

The Securities Law Alert is edited by Paul C. Gluckow (pgluckow@stblaw.com/212-455-2653), Peter E. Kazanoff (pkazanoff@stblaw.com/212-455-3525) and Jonathan K. Youngwood (jyoungwood@stblaw.com/212-455-3539).

485 U.S. 224. The Court therefore held that courts may "apply a presumption of reliance supported by the fraud-on-the-market theory," which rests on the "premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." The *Basic* Court further ruled that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance."

Justices White and O'Connor dissented in part from the majority opinion in *Basic* insofar as it adopted the fraud-on-the-market presumption of reliance. Among other concerns, the dissent stated that "the economists' theories which underpin the fraud-on-the-market presumption … are—in the end—nothing more than theories which may or may not prove accurate upon further consideration." The dissent expressed "doubt" concerning the Court's ability "to assess which theories aptly describe the functioning of the securities industry."

Recently, in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 133 S. Ct. 1184 (2013) (Ginsburg, J.),[1] four Supreme Court Justices voiced reservations concerning the continued viability of *Basic*'s fraud-on-the-market presumption. Justice Alito, concurring, observed that "recent evidence suggests that the [fraud-on-the-market] presumption may rest on a faulty economic premise" and suggested that "reconsideration of the *Basic* presumption may be appropriate." Justice Thomas, dissenting, joined by Justices Kennedy and Scalia, observed that "[t]he *Basic* decision itself is questionable" and noted that the *Basic* dissent's concerns with the economic theories underlying the fraud-on-the-market presumption "remain valid today."

1. The *Amgen* Court held that proof of materiality "is not a prerequisite to class certification" for securities fraud plaintiffs invoking *Basic*'s fraud-on-the-market presumption of reliance. Please click here to read our discussion of the *Amgen* decision in the March 2013 edition of the Alert.

Background

The underlying litigation in *Halliburton Co. v. Erica P. John Fund* (13-317) involves securities fraud claims brought against Halliburton Company and its CEO, President, and Chairman of the Board, David Lesar (collectively, "Halliburton") in connection with alleged misstatements concerning Halliburton's revenues, projected liability for asbestos claims, and the anticipated cost savings and efficiencies of Halliburton's 1998 merger with Dresser Industries.

In November 2008, the Northern District of Texas denied plaintiffs' motion for class certification based on plaintiffs' failure to establish loss causation as required under Fifth Circuit precedent. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 2008 WL 4791492 (N.D. Tex. Nov. 4, 2008) (Lynn, J.). The Fifth Circuit affirmed the district court's ruling in February 2010. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010) (Reavley, J.) (*Halliburton I*).

On June 6, 2011, the Supreme Court unanimously held that the Fifth Circuit had "erred by requiring proof of loss causation for class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (Roberts, C.J.) (*Halliburton II*).[2] The Court explained that "[l]oss causation has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory." Notably, the Court declined to address questions of "how and when [the fraud-on-the-market presumption of reliance] may be rebutted." The Court specifically "express[ed] no views on the merits" of Halliburton's contention that once the fraud-on-the-market presumption "has been successfully rebutted by the defendant," "a plaintiff must prove price impact" (in other words, that a misrepresentation actually impacted the price of a security) to win class certification.

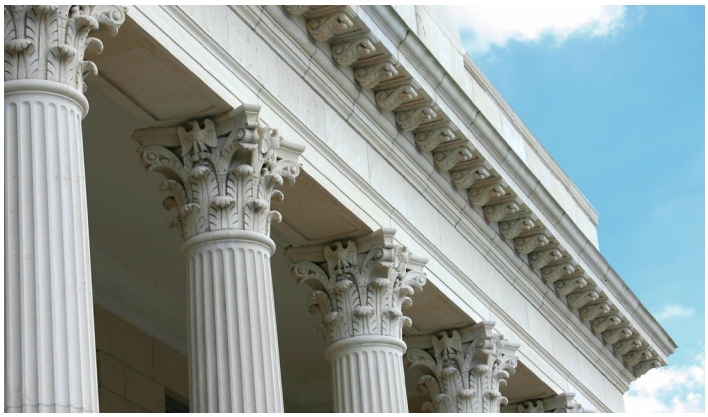
The Supreme Court remanded the action to the Fifth Circuit for consideration of any further

2. Please click here to read our discussion of the Supreme Court's decision in *Halliburton II* in the June 2011 edition of the Alert.

arguments that Halliburton had preserved in opposition to class certification. The Fifth Circuit, in turn, remanded the case to the Northern District of Texas. Before the district court, Halliburton argued that class certification was unwarranted in light of evidence that the alleged misrepresentations did not affect the price of the company's shares. The district court declined to consider this evidence, finding that defendants may not rebut the fraud-on-the-market presumption at the class certification stage by showing an absence of price impact. Halliburton appealed.

In its April 30, 2013 decision, the Fifth Circuit relied on the Supreme Court's decision in *Amgen*, 133 S. Ct. 1184, to hold that "price impact fraud-on-the-market rebuttal evidence should not be considered at class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423 (5th Cir. 2013) (Davis, J.) (*Halliburton III*).[3] The Fifth Circuit found that under *Amgen*, "the 'pivotal inquiry' when determining whether to consider a matter at [the] class certification [stage] is whether resolution of the matter" is necessary to "ensure that the *questions* of law or fact common to the class will 'predominate over any questions affecting only individual [class] members'" as required under Rule 23(b)(3). Applying this "first *Amgen* consideration," the Fifth Circuit determined that "price impact fraud-on-the-market rebuttal evidence should not be addressed at class certification" because price impact is "an objective inquiry" that "inherently applies to everyone in the class."

The Fifth Circuit explained that the "second inquiry suggested by *Amgen* is whether there is any risk that a later failure of proof on the common question of price impact will result in individual questions predominating." If a defendant could "successfully show that the price did not drop when the truth was revealed," the court observed that "no plaintiff could establish loss causation," an essential element of a claim under Section 10(b) and Rule 10b-5. The Fifth Circuit found that this "second *Amgen* consideration also leads to the conclusion that price impact fraud-on-the-market rebuttal evidence should not be addressed at class certification."



Based on its determination that "price impact evidence does not bear on … common question predominance," the Fifth Circuit held that price impact is "appropriately considered only on the merits after the class has been certified."

Halliburton petitioned the Court for certiorari of the Fifth Circuit's decision in *Halliburton III*. On November 15, 2013, the Court granted Halliburton's petition.

Halliburton Urges the Court to Overturn *Basic*'s Fraud-on-the-Market Presumption of Reliance

In its petition for certiorari, Halliburton argued that "the Court should overrule *Basic* or at least substantially modify the threshold for invoking a presumption of reliance." Petition for a Writ of Certiorari, *Halliburton Co. v. Erica P. John Fund, Inc.*, 2013 WL 4855972 (Sept. 9, 2013). Halliburton contended that "*Basic*'s central economic premise—the efficient capital markets hypothesis—has been almost universally repudiated" by economists and academics. Even in "well-developed markets, stock prices do not efficiently incorporate all types of information at all

3. Please click here to read our discussion of the Fifth Circuit's decision in *Halliburton III* in the May 2013 edition of the Alert.

times." A particular security "might trade efficiently some of the time, for some information types, but then trade inefficiently at other times, for other information types."

Halliburton further argued that "*Basic*'s legal reasoning conflicts with this Court's insistence" in *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) (Scalia, J.) and *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013) (Scalia, J.) "that class-action plaintiffs prove *in fact* that common issues predominate over individual ones." Petition for a Writ of Certiorari, 2013 WL 4855972. The *Wal-Mart* Court stated that plaintiffs must "affirmatively demonstrate … compliance" with Rule 23 in order to obtain class certification.[4] 131 S. Ct. 2541. And the *Comcast* Court held that class certification was improper where plaintiffs did not provide "evidentiary proof" that common questions would predominate over individual questions. 133 S. Ct. 1426. Halliburton posited that "*Basic*'s approach to class certification could not be more different." Petition for a Writ of Certiorari, 2013 WL 4855972. In Halliburton's view, "*Basic*'s embattled economic theory" does not "justif[y] exempting securities class actions from the requirements of Rule 23."

At a minimum, Halliburton claimed that "*Basic* should be modified to require plaintiffs to prove price impact in order to invoke the presumption in the first instance." Halliburton stated that "[i]t makes scant sense to certify enormous 'fraud-on-the-market' class actions based on disproven notions of general efficiency without inquiring whether the market was actually defrauded by the alleged misrepresentations."

4. Please click here to read our discussion of the *Wal-Mart* decision in the July 2011 edition of the Alert.

Former SEC Commissioners/Officials and Law Professors Recommend That the Court Require Section 10(b) Plaintiffs to Demonstrate Actual Reliance to Obtain Money Damages

In an amicus brief in support of Halliburton's petition for certiorari, a group of former SEC Commissioners and officials, as well as leading law professors (collectively, "Amici"), argued that "*Basic* should be overruled." Brief of Former SEC Commissioners and Officials and Law Professors as Amici Curiae in Support of Petitioners, *Halliburton Co. v. Erica P. John Fund, Inc.*, 2013 WL 5652547 (Oct. 11, 2013). Amici contended that the judiciary is "ill-equipped to assess market efficiency" and "should not be an arbiter of economic theory." Moreover, Amici pointed out "the reality" that the fraud-on-the-market presumption "is effectively *not* rebuttable." In the view of Amici, what has resulted is "a liability system that effectively dispenses with any substantial requirement of reliance."

Amici urged the Court to "require plaintiffs in Section 10(b) actions to prove actual reliance to obtain damages"[5] and stated that "[s]uch a ruling would not necessarily require that this Court overrule *Basic* outright." Rather, "the *Basic* presumption could stand

5. Amici took the position that "[b]ecause Section 10(b) does not provide for a private right of action," the Court should interpret Section 10(b) in accordance with the "most analogous" provision of the securities laws, which in their view is "unquestionably Section 18(a)" of the Exchange Act (codified at 15 U.S.C. § 78r(a)). Amici explained that Section 18(a) "authorizes damages actions for misrepresentations or omissions that affect secondary, aftermarket trading" and requires "actual, 'eyeball' reliance."

as a valid interpretation of the Section 10(b) reliance element, and remain a sufficient form of reliance in private actions not seeking money damages as relief."

The Voice of the Defense Bar Asks the Court to Permit Defendants to Rebut the *Basic* Presumption at the Class Certification Stage

In an amicus brief in support of Halliburton's petition for certiorari, The Voice of the Defense Bar[6] argued that "[t]he Fifth Circuit's rule turns what was intended to be a *rebuttable* presumption of reliance into an effectively *irrebuttable* presumption." Brief of DRI—The Voice of the Defense Bar as Amicus Curiae in Support of Petitioners, *Halliburton Co. v. Erica P. John Fund, Inc.*, 2013 WL 5652548 (Oct. 11, 2013). The Voice of the Defense Bar stated that in order "to give securities-fraud defendants a realistic opportunity to test the propriety of class certification," the Court should "make clear that a defendant can seek to rebut the presumption of reliance at any time—including at the class certification stage—with evidence that the alleged misrepresentations did not affect the stock price."

The Chamber of Commerce and the National Association of Manufacturers Argue That the *Basic* Presumption Has Raised the Cost of Doing Business

The Chamber of Commerce of the United States and the National Association of Manufacturers also filed an amicus brief in support of Halliburton's petition for certiorari. Brief for Chamber of Commerce of the United States of America and National Association of Manufacturers as Amici Curiae in Support of Petitioners, *Halliburton Co. v. Erica P. John Fund, Inc.*, 2013 WL 5652546 (Oct. 11, 2013). The two organizations argued that the judicial application of *Basic*'s fraud-on-the-market presumption "has provided securities fraud plaintiffs with a free pass to class certification in many cases." The consequent "excess of securities class action litigation has inflicted a tremendous drain on U.S. public companies and their investors."

Erica P. John Fund Defends the Continuing Validity of *Basic*'s Fraud-on-the-Market Presumption

In opposition to Halliburton's petition for certiorari, the Erica P. John Fund argued that *Basic*'s fraud-on-the-market presumption "has been repeatedly endorsed" by the Supreme Court, Congress, the SEC, and the DOJ. Brief in Opposition, *Halliburton Co. v. Erica P. John Fund, Inc.*, 2013 WL 5652544 (Oct. 11, 2013). Quoting *Amgen*, 133 S. Ct. 1184, the Fund pointed out that although Congress has "tak[en] steps to curb abusive securities-fraud lawsuits," it has "rejected calls to undo the fraud-on-the-market presumption of classwide reliance endorsed in *Basic*."

The Fund emphasized that "[t]he fraud-on-the-market presumption is crucial to private securities actions," which can "promote[ ] public and global confidence in our capital markets and help[ ] to deter wrongdoing." It urged the Court to "decline Halliburton's invitation to abandon twenty-five years of established precedent and eliminate or hamstring the ability of private parties to bring securities fraud actions."

* * *

The Supreme Court will hear oral argument in the *Halliburton* case on March 5, 2014. We will report on the oral argument in the March 2014 edition of the Alert.

6. The Voice of the Defense Bar is an international organization comprised of more than 23,000 civil defense attorneys.

Third Circuit Holds Public Has a First Amendment Right of Access to Delaware's Arbitration Program for Business Disputes

On October 23, 2013, the Third Circuit held that "the public has a right of access under the First Amendment to Delaware's state-sponsored arbitration program" for business disputes, overturning Delaware law which allowed the proceedings to be kept confidential. *Del. Coalition for Open Govt., Inc. v. Strine*, 733 F.3d 510 (3d Cir. 2013) (Sloviter, J.) (*Del. Coalition II*).

Background

In 2009, the State of Delaware empowered the Court of Chancery to arbitrate business disputes. Pursuant to this authority, the Court of Chancery "created an arbitration process as an alternative to trial for certain kinds of [business] disputes." Court-sponsored arbitration is available only if certain criteria are met: at least one party must be a "business entity formed or organized" under Delaware law; neither party may be a "consumer"; and the dispute must involve an amount-in-controversy of at least $1 million. 10 Del. Code Ann. tit. 10 § 347(a)(3-5). Parties must pay a filing fee of $12,000 to commence arbitration proceedings, as well as costs of $6,000 per day after the first day of arbitration.

Delaware Chancery Court judges preside over the arbitration proceedings, and have the power to "grant any remedy or relief" that they "deem[ ] just and equitable and within the scope of any applicable agreement of the parties." Del. Ch. R. 98(f)(1). After the judge reaches a decision, "a final judgment or decree is automatically entered." *Del. Coalition II*, 733 F.3d 510. "Both parties [then] have a right to appeal the resulting 'order of the Court of Chancery' to the Delaware Supreme Court, but that court reviews the arbitration using the deferential standard outlined in the Federal Arbitration Act." *Del. Coalition II*, 733 F.3d 510 (quoting 10 Del. Code Ann. tit. 10 § 349(c)).

Both the Delaware Code and the governing Court of Chancery Rules "bar public access" to arbitration proceedings and filings. "Arbitration petitions are 'considered confidential' and are not included 'as part of the public docketing system' … 'until such time, if any, as the proceedings are the subject of an appeal.'" *Del. Coalition II*, 733 F.3d 510 (quoting 10 Del. Code Ann. tit. 10 § 349(b)); Del. Ch. R. 97. "The Delaware Supreme Court has yet to adopt rules that would govern the confidentiality of appeals from Delaware's arbitration program, and there is no record of an appeal from an arbitration award."

The Delaware Coalition for Open Government brought suit in the District of Delaware "arguing that the confidentiality of Delaware's government-sponsored arbitration proceedings violated the First Amendment." In August 2012, the district court found that a Delaware arbitration proceeding "functions essentially as a non-jury trial before a Chancery Court judge" and therefore "must be open to the public." *Del. Coalition for Open Government v. Strine*, 894 F. Supp. 2d 493 (D. Del. 2012) (McLaughlin, J.). Chancellor Leo E. Strine, Jr. and the Delaware Chancery Court judges responsible for overseeing these arbitration proceedings appealed.

Third Circuit Finds "Experience and Logic" Test Governs the Public's Right of Access to Delaware's Arbitration Proceedings

At the outset of its analysis, the Third Circuit explained that "[a] proceeding qualifies for the First Amendment right of public access when 'there has been a tradition of accessibility' to that kind of proceeding, and when 'access plays a significant positive role in the functioning of the particular process in question.'" *Del. Coalition II*, 733 F.3d 510 (quoting *Press-Enter. Co. v. Superior Ct.*, 478 U.S. 1 (1986)). This "examination of the history and functioning of a proceeding has come to be known as the 'experience and logic' test." In order for plaintiffs "to qualify for public access, both experience and logic must counsel in favor of opening the proceeding to the public." Once plaintiffs establish a presumption of public access under the experience and logic test, "it may only be overridden by a compelling government interest."

The Third Circuit determined that the district court had erred in "bypass[ing] the experience and logic test" and deciding the issue based solely on the similarities between a Delaware government-sponsored arbitration and a civil trial. "Although Delaware's arbitration proceeding shares a number of features with a civil trial," the Third Circuit found that "the two are not so identical as to fit within the narrow exception articulated by the Supreme Court in" *El Vocero de Puerto Rico v. Puerto Rico*, 508 U.S. 147 (1993).[7] The Third Circuit explained that it "therefore must examine Delaware's proceeding under the experience and logic test."

Third Circuit Finds the "Experience and Logic Test" Mandates Public Access to Delaware Government-Sponsored Arbitrations

Pursuant to the "experience prong of the experience and logic test," the Third Circuit first "consider[ed] whether 'the place and process have historically been open to the press and general public.'" The Third Circuit found that "an exploration of both civil trials and arbitrations [was] appropriate" in light of the "broad historical approach" courts have generally taken in First Amendment public access cases. The court acknowledged the "long history of access to civil trials." In the modern day, "civil trials and the court filings associated with them are generally open to the public." Arbitrations, on the other hand, "have often been closed" to the public, "especially in the twentieth century."

"Taking the private nature of many arbitrations into account," the Third Circuit concluded that "the history of civil trials and arbitrations demonstrates a strong tradition of openness for proceedings like Delaware's government-sponsored arbitrations." The court found that Delaware's arbitration proceedings "differ fundamentally" from "arbitrations with non-state action in private venues," which "tend to be closed to the public." Unlike private arbitrations, Delaware's arbitration proceedings "are conducted before active

7. The *El Vocero* Court held that the public had a right of access to preliminary criminal hearings in Puerto Rico because the hearings were "'sufficiently like … trial[s].'" 508 U.S. 147.

judges in a courthouse," "result in a binding order of the Chancery Court," and "allow only a limited right of appeal." The Third Circuit found that the "experience inquiry therefore counsels in favor of granting public access to Delaware's proceedings because both the 'place and process' of Delaware's proceedings 'have historically been open to the press and general public.'"

Turning to the logic prong of the "experience and logic" test, the Third Circuit next "examine[d] whether 'access plays a significant positive role in the functioning of the particular process in question.'" The court found that "[t]he benefits of openness weigh strongly in favor of granting access to Delaware's arbitration proceedings." First, "[a]llowing public access to state-sponsored arbitrations would give stockholders and the public a better understanding of how Delaware resolves major business disputes." Moreover, "[o]pening the proceedings would … allay the public's concerns about a process only accessible to litigants in business disputes who are able to afford the expense of arbitration." Allowing "public access would [also] expose litigants, lawyers, and the Chancery Court judge alike to scrutiny from peers and the press." In addition, "public access would discourage perjury and ensure that companies could not misrepresent their activities to competitors and the public."

Compared to these "significant" benefits, the Third Circuit found that "the drawbacks of openness … are relatively slight." The court explained that "[a] possible decrease in the appeal of the proceeding and a reduction in its conciliatory potential are comparatively less weighty" than "ensur[ing] accountability and allow[ing] the public to maintain faith in the Delaware judicial system." The Third Circuit therefore determined that "logic weighs in favor of granting access to Delaware's government-sponsored arbitration proceedings."

Based on its application of the "experience and logic" test, the Third Circuit held that "there is a First Amendment right of access to Delaware's government-sponsored arbitrations."

Concurrence States That the Decision Only Impacts the Confidentiality Provisions of Delaware's Arbitration Program

In a concurring opinion, Judge Fuentes explained that "not all provisions of § 349 of the Delaware Code or the Chancery Court Rules relating to Judge-run arbitration proceedings are unconstitutional." Judge Fuentes clarified that "[n]othing in [the] decision should be construed to prevent sitting Judges on the Court of Chancery from engaging in arbitrations without [the] confidentiality provisions" at issue.

Dissent Finds the "Experience and Logic" Test Bars Public Access

In a dissenting opinion, Judge Roth found it "very clear" that Delaware's arbitration proceedings were modeled on "traditional arbitration[s], in a confidential setting" and were never "intend[ed] … to supplant civil trials." Applying the experience prong of the "experience and logic" test, Judge Roth emphasized that arbitration has "historically … been private and confidential." Judge Roth also explained that "[l]ogically, the resolution of complex business disputes, involving sensitive financial information, trade secrets, and technological developments, needs to be confidential so that the parties do not suffer the ill effects of this information being set out for the public—and especially competitors—to misappropriate." She concluded that "there is … no First Amendment right of public access" to Delaware's arbitration proceedings.

Third Circuit Affirms Dismissal of a Securities Fraud Action Against Kid Brands on Scienter Grounds

On November 15, 2013, the Third Circuit affirmed dismissal with prejudice of a securities fraud action against Kid Brands and several of its executives based on plaintiffs' "fail[ure] to plead scienter with sufficient particularity." *Rahman v. Kid Brands, Inc.*, 2013 WL 6038246 (3d Cir. Nov. 15, 2013) (Greenberg, J.).

Background

Kid Brands is an importer of inexpensive children's furniture and products. In December 2010, U.S. Customs and Border Protection advised Kid Brands that it had initiated a 'Focused Assessment' of the company's import practices and procedures. Kid Brands' board of directors hired an outside law firm to commence an internal investigation of the issues raised by the agency. However, Kid Brands "did not publicly disclose that it was subject to the Focused Assessment or that it had hired the law firm until after it [had] received a report from the firm" regarding the internal investigation.

On March 15, 2011, Kid Brands publicly disclosed that one of its wholly owned subsidiaries—LaJobi, Inc.—had misidentified the manufacturer and shipper of certain products in violation of U.S. law. Kid Brands further disclosed that it anticipated paying $7 million in charges and fines to resolve issues in connection with the Focused Assessment. On the day of the announcement, "Kid Brand's stock closed at $6.91 a share, a large drop from its prior day closing price of $9.24."

Five months later, on August 15, 2011, Kid Brands disclosed that two of its other subsidiaries had also evaded customs duties. The following day, "Kid Brands issued a Form 8-K that estimated its total liabilities

to be in excess of $10 million for wrongful practices extending over a period of nearly five years."

Plaintiffs subsequently brought the instant securities fraud action alleging that defendants had "misled investors … by issuing deceptive public financial reports and press releases dealing with Kid Brands' compliance with customs laws and overall financial performance." In support of their scienter allegations, plaintiffs relied primarily on statements by confidential witnesses. On October 17, 2012, the District of New Jersey dismissed the complaint with prejudice for failure to meet the heightened scienter pleading standard set forth in the Private Securities Litigation Reform Act ("PSLRA"). Plaintiffs appealed.

Third Circuit Finds Plaintiffs' Confidential Witness Allegations Should Be Discounted

The Third Circuit explained that "[w]here plaintiffs rely on confidential personal sources but also on other facts," plaintiffs "need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false." The court noted that "there is no requirement that [confidential witnesses] be named, provided they are described in the complaint with sufficient

particularity to support the probability that a person in the position occupied by the source would possess the information alleged."

"[W]hen dealing with confidential witnesses," the Third Circuit stated that "courts should assess the 'detail provided by the confidential sources, the sources' basis of knowledge, the reliability of the sources, the corroborative nature of other facts alleged, including from other sources, the coherence and plausibility of the allegations, and similar indicia.'" *Rahman*, 2013 WL 6038246 (quoting *Institutional Investors Grp. v. Avaya, Inc.*, 564 F.3d 242 (3d Cir. 2009)). "If, after that assessment, 'anonymous source allegations are found wanting with respect to these criteria … [courts] must discount them steeply.'" The Third Circuit explained that "such a discount is consistent with" *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), which holds "that omissions and ambiguities count against inferring scienter under the PSLRA's particularity requirements." *Rahman*, 2013 WL 6038246.

Applying this standard, the Third Circuit found that "such discounting is necessary in this case." Here, Confidential Witness ("CW") 1 "stated that he was in charge of re-labeling furniture from China with stickers containing a different country of origin, and CW2 confirmed his account." CW2 claimed that "LaJobi management [had] conferred with the Kid Brands leadership … about the protocol for altering the country of origin labels." However, the court noted that "CW2 did not begin working for LaJobi until June 2011, so CW2 [could not] have [had] personal knowledge regarding the pre-investigation violations." The Third Circuit also found that "neither CW2 nor CW1 had any way of knowing what was discussed in those [alleged] closed-door meetings between the LaJobi and Kid Brands leadership."

CW3 proffered "abstract commentary" to the effect that he had "'a feeling something suspicious was going on." CW5 provided only "general information regarding meetings between the Kid Brands and LaJobi leadership." CW6 was "enmeshed in an employment dispute that had no bearing on the customs violations in question." The Third Circuit found that "[o]f all the confidential witnesses, the statements of CW4 were the most plausible" because he "allegedly spent more than five years reviewing Kid Brands' internal financial information." But "even CW4 … offer[ed] little more than generalized allegations with few specifics and even less concrete support."

Turning to the remainder of plaintiffs' scienter allegations, the Third Circuit found it significant that plaintiffs "did not demonstrate that the individual defendants had a motive for their wrongful conduct." The court explained that although "it is not necessary to plead motive to establish that a defendant acted with scienter, its presence can be persuasive when conducting a holistic review of the evidence." The Third Circuit further determined that the allegations did not "support the existence of corporate or collective scienter" because "there [was] no credible evidence to suggest that Kid Brands covered up the customs violations at its subsidiary."[8] "Quite to the contrary, when U.S. Customs notified Kid Brands of the Focused Assessment, Kid Brands hired an outside law firm to conduct an internal investigation and, when it received a report from the firm, it publicly disclosed both the existence of the Focused Assessment and the remedial steps it had taken."

8. The Third Circuit noted that it had "neither … accepted nor rejected the doctrine of corporate scienter in securities fraud actions."

The Third Circuit also found "unavailing" plaintiffs' reliance on the core operations doctrine recognized in *Avaya*, 564 F.3d 242. The court explained that "corporate management's general awareness of the day-to-day workings of the company's business does not establish scienter—at least absent some additional allegations of specific information conveyed to management and related to fraud." (quoting *Metzler Inv. GMBH v. Corinthian Colls., Inc.*, 540 F.3d 1049 (9th Cir. 2008)). Moreover, the court "point[ed] out that the core operations doctrine cannot apply [here] because … the $10 million in anticipated liabilities covering wrongful conduct over a nearly five-year span cannot be regarded as affecting the 'core operations' of a company that had hundreds of millions of dollars in annual net sales."

The Third Circuit concluded that the complaint "fail[s] to meet the heightened pleading requirements of the PSLRA," and affirmed dismissal of the complaint with prejudice.

Southern District of New York Denies Motions to Dismiss the MF Global Securities Fraud Action

On November 12, 2013, the Southern District of New York denied motions to dismiss a securities fraud action brought in connection with the October 2011 collapse of MF Global Holdings Limited. *In re MF Global Holdings Ltd. Sec. Litig.*, 2013 WL 5996426 (S.D.N.Y. Nov. 12, 2013) (Marrero, J.). The court found that "[p]laintiffs' allegations suggest a long, knowing, and consistent course of action on the part of the various [d]efendants … that cumulatively produced the harmful outcome that came to pass." The court reasoned that "if on this record as pled [p]laintiffs cannot make out a plausible claim here, they could not make it anywhere."

Background

MF Global was a major commodities brokerage firm run by Jon S. Corzine, who served as Chairman of the Board and CEO of both MF Global and its broker-dealer subsidiary from March 23, 2010 to November 4, 2011.

On October 25, 2011, MF Global reported a loss of $191.6 million in its Form 10-Q. $119.4 million of this loss represented a valuation allowance against MF Global's Deferred Tax Assets ("DTA")—the "losses, credits, and other tax deductions that may be used to offset taxable income in the future." MF Global's stock fell by 48 percent on the day it filed its October 2011 Form 10-Q.

Around the same time, MF Global's strategy of investing in European sovereign debt through repurchase-to-maturity ("RTM") transactions "began to unravel." The company's counterparties "demanded additional margin to cover the transactions," leaving MF Global "struggl[ing] to meet the increased liquidity demands." The downward spiral continued on October 29, 2011, when "MF Global discovered a [$1.6 billion] shortfall in its customer funds account." Two days later, MF Global declared bankruptcy.

Plaintiffs subsequently filed the instant securities fraud action alleging that "MF Global's public filings and the public statements made by MF Global's officers [had] materially misled investors in two ways." First, plaintiffs contended that Generally Accepted

Accounting Principles ("GAAP") required MF Global to record a valuation allowance against its DTA prior to October 25, 2011. Second, plaintiffs claimed that defendants had "(1) purposefully concealed the proprietary nature of the RTM transactions, (2) materially misstated and failed to disclose how the RTM strategy posed significant liquidity risks to the Company, and (3) misrepresented and failed to disclose weaknesses in MF Global's ability to prevent a liquidity crisis of the kind that caused MF Global's eventual collapse." Plaintiffs asserted claims under both the Exchange Act and the Securities Act. Defendants moved to dismiss the complaint in its entirety.

Court Finds the Complaint Meets the Pleading Requirements of Rules 8(a) and 9(b) and the PSLRA

As an initial matter, the court addressed defendants' "suggest[ion] that [p]laintiffs' exhaustive pleadings give [d]efendants both too much detail and too little—more information than necessary to present a concise statement of the facts" as required by Rule 8(a) and "yet not enough to give [d]efendants fair notice of why they [were] being sued" as required by Rule 9(b) and the Private Securities Litigation Reform Act ("PSLRA"). The court acknowledged that "in some respects," plaintiffs were "stuck between the proverbial rock of Rule 8(a) and the proverbial hard place of Rule 9(b) and the PSLRA." But the court found that "in cases like this one, with particularly complex facts, some flexibility is warranted" in applying these pleading standards.

Here, the court determined that the complaint "sufficiently achieves the goals embodied within Rule 8(a), Rule 9(b), and the PSLRA, which are 'to provide a defendant with fair notice of a plaintiffs' claim, safeguard his reputation from improvident charges of wrongdoing, and protect him against strike suits.'" The court pointed out that "[d]efendants' briefs in support of their motions to dismiss, which forcefully and directly attack [p]laintiffs' allegations of wrongdoing, are themselves proof that [d]efendants have notice of the claims against them." While the complaint "*could* state more particularly which of the reasons the statements are alleged to be false applies to which of the allegedly false statements," the court found that "Rule 9(b) and the PSLRA do not require such an extreme level of particularity."

Court Holds Opinion-Based Securities Act Claims Do Not Always Sound in Fraud for Pleading Purposes

Plaintiffs characterized their Securities Act claims as "non-fraud claims" and "expressly disclaim[ed] any allegations of scienter" with respect to those claims. However, plaintiffs alleged that any "challenged statements of opinion or belief" were "materially misstated statements of opinion or belief when made." The court found that this disclaimer reflected "an effort to comply" with *Fait v. Regions Financial Corp.*, 655 F.3d 105 (2d Cir. 2011). In that case, the Second Circuit held that in order to state a claim under Sections 11 or 12 of the Securities Act based on alleged misstatements of opinion, plaintiffs "must allege that defendant's opinions were both false and not honestly believed when they were made."[9] *Fait*, 655 F.3d 105.

Given plaintiffs' *Fait* disclaimer, defendants "argue[d] that the Securities Act claims do, in fact, sound in fraud and must be pled with particularity." *MF Global*, 2013 WL 5996426. Defendants contended that "[p]laintiffs' claim that any opinions were false when made turn[ed] the Securities Act claims into claims requiring proof of fraud, which in turn require[d] [p]laintiffs to plead those claims with particularity

9. Please click here to read our discussion of the *Fait* decision in the September 2011 edition of the Alert.

under Rule 9(b)."

The Southern District of New York rejected defendants' argument in light of the Second Circuit's recent decision in *Freidus v. Barclays Bank PLC*, 2013 WL 4405291 (2d Cir. Aug. 19, 2013) (Parker, J.). In *Freidus*, the Second Circuit determined that "the district court [had] erred in stating that claims of disbelief of subjective opinions must necessarily be brought as fraud claims." 2013 WL 4405291. The *Freidus* court noted that in *Fait*, the Second Circuit had held that "allegations of disbelief of subjective opinions are not the same as allegations of fraud."[10]

Relying on *Freidus*, the *MF Global* court found it "clear" that "a complaint can plead that opinions were subjectively disbelieved when made while not also sounding in fraud." 2013 WL 5996426. The court nonetheless determined that even if the Securities Act claims at issue sounded in fraud, plaintiffs' allegations were sufficient to meet Rule 9(b)'s requirements.

Court Finds DTA-Related Statements Were Opinions That Were Not Believed When Made

The court then turned to plaintiffs' claims that MF Global had made material misstatements regarding its DTA and net income based on its failure to timely record a valuation allowance against its DTA. At the outset, the court first considered whether these statements constituted opinions under *Fait*. While the court observed that *Fait* "did not comprehensively delineate the difference between a statement of opinion and a statement of fact," the court noted that the *Fait* court held that statements concerning goodwill and loan loss reserves were opinions because there was no objective standard against which to measure either.

Applying "*Fait*'s reasoning," the court found it significant that plaintiffs did "not identif[y] an objective standard that should have been applied" when MF Global considered whether and when to take a valuation allowance against DTA. Rather, the applicable GAAP standard "required MF Global's management to weigh the available evidence and determine whether DTA was 'more likely than not to be realized' … 'a very subjective standard.'" The court concluded that the DTA-related statements were opinions governed by *Fait*'s pleading requirements.

The court next considered "whether the statements 'were both false and not honestly believed at the time they were made'" as required under *Fait*. The court concluded that plaintiffs had "pled sufficient facts to meet this standard." "First," the court determined that plaintiffs "plausibly allege[d] that MF Global's statements about its DTA were objectively false" because "MF Global's United States operations were in a three-year loss position at the start of the Class Period." Moreover, because "MF Global took some small valuation allowances against its DTA during the Class Period," the court found it "more plausible that the Company's failure to take an allowance against the full value of its DTA was materially misleading."

As to the question of whether defendants "did not honestly believe their stated opinions" regarding DTA, the court found the complaint sufficiently alleged that

10. The *Fait* court stated that it did "not view a requirement that a plaintiff plausibly allege that defendant misstated his truly held belief and an allegation that defendant did so with fraudulent intent as one and the same." 655 F.3d 105.

MF Global executives "(1) were aware of the relevant GAAP accounting standard and (2) knew that the positive evidence on which they relied would not be sufficient for MF Global to realize its DTA." Based on these allegations, the court held that plaintiffs were "entitled to a reasonable inference that [defendants] subjectively believed that MF Global should take a valuation allowance against its DTA, despite their public statements to the contrary."

Finally, the court found that the bespeaks-caution doctrine did not preclude liability for the DTA-related claims because MF Global's "disclosures refer[red] *generally* to potential unexpected events or contingencies that *might* have prevented MF Global from realizing the full value of its DTA." These "disclosures did not specifically reveal the particular risks known to MF Global" and thus "fell short of the more specific qualifications that courts have found sufficient under the bespeaks caution doctrine."

Court Holds Plaintiffs Adequately Alleged RTM-Related Misstatements

With respect to alleged misstatements regarding MF Global's RTM strategy, the court determined that the complaint adequately "pleads actionable misstatements with respect to MF Global's assurances that the Company operated within specified risk limits." The court further found that the complaint pleads "actionable misstatements about MF Global's risk controls," "the risks posed by the RTM strategy," and "MF Global's capital and liquidity management."

As to defendants' argument that the complaint "merely pleads inactionable fraud by hindsight," the court explained that the market's negative reaction to MF Global's disclosure of its risk exposure in 2011 "buttress[ed] a reasonable inference that MF Global's statements would have materially misled a reasonable investor." The court also found that the complaint "survive[d] a fraud-by-hindsight objection" because plaintiffs adequately alleged that defendants "'had present knowledge of the risk' that was not disclosed."

Defendants further claimed that their statements were protected by the bespeaks-caution doctrine and the PSLRA's safe harbor for forward-looking statements because of "disclosures that the Company might increase trading risk, or might not hold sufficient capital or liquidity to meet market demands." However, the court found these warnings "insufficient 'in light of the undisclosed hard facts critical to appreciating the magnitude of the risks described.'" "By superficially warning of possible risks while failing to disclose critical facts, MF Global was akin 'to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away.'"

The court rejected defendants' remaining challenges, and denied defendants' motions to dismiss in their entirety.

NEW YORK

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

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

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

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

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

Nicholas Goldin
212-455-3685
ngoldin@stblaw.com

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

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

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

Linda H. Martin
212-455-7722
lmartin@stblaw.com

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

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

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

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

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

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

Mary Kay Vyskocil
212-455-3093
mvyskocil@stblaw.com

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

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

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

LOS ANGELES

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

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

PALO ALTO

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

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

WASHINGTON, D.C.

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

Cheryl J. Scarboro
202-636-5529
cscarboro@stblaw.com

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

"[U]niformly talented lawyers who are especially experienced and well versed in securities litigation."

—CHAMBERS USA 2013

UNITED STATES

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

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

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

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

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

EUROPE

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

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

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

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

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