Forum for | US Securities Lawyers | in London

US Securities Update:

Overview of Important US Securities Law Related Federal Court Cases in 2011/12

April 2012

The Forum intends to publish legal updates on a regular basis going forward and as such is starting with the following round-up of significant cases which have been decided over the last year or so.

The year 2011 and beginning of 2012 have seen a heavier than usual volume of Supreme Court and Second Circuit decisions on securities law questions, in particular securities fraud litigation involving material misstatements to the market. Opinions that have eased the initial requirements for class certifications in securities fraud class actions under Rule 10b-5 of the Exchange Act have been counterbalanced by limitations on the types of parties who can be sued in such private rights of action and on the territorial reach of the Exchange Act as well as other US federal statutes.

Materiality and reliance are fact-specific enquiries that are not dependant on a requirement to prove loss causation or to show statistical data for certification of securities fraud class actions

In the first half of 2011, the US Supreme Court granted two securities fraud class action certifications in actions brought under Section 10(b) and Rule 10b-5 of the Exchange Act. In *Matrixx Initiatives v. Siracusano* and *Erica P. John Fund v. Halliburton*, the Court reaffirmed certain tenets of *Basic v. Levinson* with regard to materiality, reliance and causation.

Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. ___ (2011)

In March 2011, in *Matrixx Initiatives v. Siracusano*, the Supreme Court rendered a unanimous decision on the subject of materiality in securities fraud claims under Section 10(b) and Rule 10b-5 of the Exchange Act. The Court rejected the proposition that reports of adverse events associated with a pharmaceutical company's products must be statistically significant in number to be material to investors. Instead of reducing materiality to a bright-line rule or any one particular factor such as statistical significance, the Court cited to the standard set forth in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). This fact-specific enquiry asks whether there was "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" to the investor.

Defendant Matrixx had been subject to product liability lawsuits in respect of one of its leading products, a cold remedy which it was alleged had caused consumers to lose their sense of smell (a condition called anosmia). Scientific studies were carried out on the product but were not statistically significant enough to prove causation in respect of the alleged injuries. According to the Court, such studies did not have to be statistically significant in order to constitute material information. Matrixx's failure to disclose their existence, along with its projections that revenues would increase by 50% and then 80%, were actionable material misstatements or omissions. The Court also based its decision on the availability of other sources besides statistical data that could be used by medical experts and regulators to infer causation between the drug and anosmia. The Court rejected the defendant's argument that the data from the studies was too anecdotal to plead scienter (the requisite intent to defraud) and found that nondisclosure gave rise to a cogent and compelling inference of deliberate recklessness.

The *Matrixx Initiatives v. Siracusano* US Supreme Court decision is available at http://www.supremecourt.gov/opinions/10pdf/09-1156.pdf

Erica P. John Fund, Inc. v. Halliburton Co., 563 U.S. ___ (2011)

In June 2011, in *Erica P. John Fund v. Halliburton*, the Supreme Court held that for class certification of a Rule 10b-5 securities fraud claim, the plaintiffs did not have to prove loss causation (*i.e.*, that the defendant's conduct had caused the economic loss). This decision resolved a conflict among the circuits in respect of the commonality requirement of Federal Rule of Civil Procedure 23(b)(3) for class certifications.

Rule 23(b)(3) requires that common questions of law or fact predominate among members of the class over any questions affecting solely individuals. Halliburton had allegedly made certain misrepresentations about its potential liability from asbestos litigation as well as its construction contracts and a company merger, which plaintiffs claimed had caused the share price to become distorted and precipitated their economic loss. According to the Court, the commonality requirement in a securities fraud class action often turns on a showing of plaintiffs' reliance on the misrepresentation. The Court found that such reliance could be presumed, under the "fraud-on-the-market" theory, by virtue of the efficient market assumption that the price of shares traded on a well-developed market reflects all publicly available information including material misrepresentations. In order to invoke this rebuttable presumption of reliance set forth in *Basic v. Levinson*, plaintiffs had to show that the misstatements were publicly known, that the stock was trading in an efficient market and that the relevant trade was executed after the misrepresentation was made and before it was corrected. The plaintiffs did not have to prove loss causation at the class certification stage as this "would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market".

The *Erica P. John Fund v. Halliburton* US Supreme Court decision is available at http://www.supremecourt.gov/opinions/10pdf/09-1403.pdf

Limitations on the types of defendants who can be held liable

Two additional cases in 2011, one heard by the Supreme Court and another by the Second Circuit, indicated a tendency to narrowly delineate the scope of liability in actions for fraud to exclude parties other than the primary actor who directly perpetrated the fraud. Both such opinions, *Janus Capital Group, Inc. v. First Derivative Traders* and *MLSMK Investment Company v. JP Morgan*, relied on the 1994 Supreme Court case of *Central Bank of Denver v. First Interstate Bank of Denver*, which held that aiders and abettors could not be liable in a private cause of action under Section 10(b) of the Exchange Act.

Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. ___ (2011)

In June 2011, in *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court held 5-to-4 that the "maker" of a false statement for purposes of primary liability in private Rule 10b-5 claims had to be the one with "ultimate authority" over it, including its content and dissemination, not merely someone who published the statement on behalf of another.

Janus Capital Management (JCM) was an investment advisor and its holding company, Janus Capital Group (JCG), had created Janus Investment Fund (the Fund), a separate entity owned entirely by mutual fund investors. JCM and JCG had been involved in preparing and disseminating the Fund's prospectuses but nevertheless could not be held liable under Section 10(b) or Rule 10b-5 of the Exchange Act for false statements made in such prospectuses that caused loss to JCG's shareholders. When it was discovered that JCG had made secret arrangements to permit market timing trades following statements in the Fund prospectus that JCG and JCM would implement policies to curb such trades, investors withdrew their Fund assets. This reduced JCM's management fees, which plaintiff claims negatively impacted JCG's share price. The Court observed that, in spite of their "uniquely close relationship", common executives and the substantial control which JCM held over the Fund including by managing its assets and determining its strategies, the two were distinct legal entities with separate corporate formalities. The Fund had an independent board of trustees and filed its own prospectuses as it alone was statutorily required to do so (though such prospectuses were posted on JCM's website). This narrow interpretation of

Rule 10b-5 was partly attributable to the Court's reluctance to expand the rule's applicability as a judicially implied (rather than legislated) right of action. The majority's reliance on *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (further described below under *MLSMK Investment Company v. JP Morgan*) was criticised as misplaced by the dissenting justices, who pointed out that that case concerned aiding and abetting, and not primary, liability for securities fraud.

While the *Janus* Court's holding was applicable only to private rights of action under Rule 10b-5, it is unclear whether and to what extent the case may affect SEC enforcement actions under Section 10(b) of the Exchange Act.

The *Janus Capital Group, Inc. v. First Derivative Traders* US Supreme Court decision is available at http://www.supremecourt.gov/opinions/10pdf/09-525.pdf

MLSMK Investment Company v. JP Morgan Case & Co., JP Morgan Chase Bank, NA

In July 2011, in *MLSMK Investment Company v. JP Morgan*, the Second Circuit affirmed the lower court's dismissal of an appeal by MLSMK Investment Company against JP Morgan surrounding the fraudulent activities of Bernard L. Madoff Investment Securities (BMIS). This case was heard in the wake of Madoff's criminal activities including the illusory BMIS investment advisory business and Ponzi scheme which had defrauded investors of billions of dollars through fictitious trades and payouts from other investors' contributions. JP Morgan had been BMIS's market-making trading partner and maintained accounts for Madoff, from which it received fee income. In late summer 2008, JP Morgan investigated Madoff's activities and discovered that they were fraudulent but continued to trade with and provide services to him instead of freezing his accounts.

MLSMK's claims against JP Morgan included conspiracy to violate the Racketeer Influenced and Corrupt Organizations Act (RICO) and aiding and abetting Madoff's breach of fiduciary duty, as well as commercial bad faith and negligence. The district court's dismissal of the state-law aiding and abetting claims in respect of fiduciary duty, commercial bad faith and negligence was affirmed by the Second Circuit. This opinion focussed on the RICO conspiracy claim. The Second Circuit held that the RICO conspiracy claim was precluded by Section 107, the so-called "RICO Amendment", to the Private Securities Litigation Reform Act of 1995 (PSLRA). The Court found that "the RICO Amendment bars claims based on conduct that could be actionable under the securities laws even when the plaintiff, himself, cannot bring a cause of action under the securities laws". Such reference to the plaintiff's inability to bring a securities fraud claim was derived from the holding of *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (a case also cited by the *Janus* Court), which held that aiders and abettors could not be liable in a private right of action for securities fraud under Section 10(b) of the Exchange Act. The Second Circuit's decision resolved a conflict among the lower courts in holding that the RICO Amendment did not only bar RICO claims based on predicate actionable claims of securities fraud against the named defendant, but also those such as for aiding and abetting which could not be brought under Section 10(b) by private plaintiffs.

The *MLSMK Investment Company v. JP Morgan* Second Circuit decision is available at http://caselaw.findlaw.com/us-2nd-circuit/1573232.html

Limitations on the extraterritorial reach of the Exchange Act, Sarbanes-Oxley Act and other U.S. federal laws

Three federal cases in 2011-2012 reflect the recent trend of limiting the extraterritorial applicability of US securities and other laws. *Morrison v. National Australia Bank* was decided by the Supreme Court, *Villanueva v. Core Laboratories* was heard by a US Department of Labour tribunal, and *Absolute Activist Value Master Fund v. Ficeto* was heard by the Second Circuit. *Morrison v. National Australia Bank* and *Absolute Activist* have limited the private right of action under Rule 10b-5 to domestic transactions. *Villaneuva* confirms the limited domestic reach of the whistleblower provisions of the Sarbanes-Oxley Act.

Morrison v. National Australia Bank Ltd., 561 U.S. ___ (2010)

In June 2010, in *Morrison v. National Australia Bank Ltd.*, the US Supreme Court limited the extraterritorial reach of Section 10(b), the anti-fraud provision of the Securities and Exchange Act.

The plaintiffs in *Morrison* were Australian shareholders of an Australian bank who claimed that the bank committed securities fraud by allegedly manipulating the publicly reported valuations of a Florida-based subsidiary. National Australia Bank's shares were publicly traded on the Australian Stock Exchange and its ADRs listed on the New York Stock Exchange. The Supreme Court rejected the "conducts and effects" test used in previous cases in favour of a "transactional" test under a presumption against extraterritoriality. The Court held that the anti-fraud provisions of Rule 10b-5 and Section 10(b) under the Exchange Act did not extend to non-US securities transactions conducted over a non-US exchange, even though a portion of the underlying fraudulent conduct occurred in the United States. The Court's ruling limited the applicability of Section 10(b) to securities transactions executed over a domestic exchange and to so-called "domestic" transactions. While the *Morrison* Court did not elaborate on what would constitute a domestic transaction in securities not listed on a US exchange, the Second Circuit has since then provided further guidance in *Absolute Activist Value Master Fund v. Ficeto* (as described below).

The *Morrison* decision is further discussed under Forum News: June 28, 2010: "Update on Extraterritorial reach of Section 10(b) and Rule 10b-5 Liability: Supreme Court Ruling in *Morrison v. National Australia Bank Limited*".

The *Morrison v. National Australia Bank* US Supreme Court decision is available at http://www.supremecourt.gov/opinions/09pdf/08-1191.pdf.

Villanueva v. Core Laboratories NV

In December 2011, in *Villanueva v. Core Laboratories NV*, a US Department of Labor tribunal applied Morrison to limit the extraterritorial reach of the whistleblower provisions of the Sarbanes-Oxley Act (Section 806 of the Act). In *Villanueva*, a Colombian CEO of a Dutch company's Colombian subsidiary claimed retaliation and wrongful termination by the subsidiary after the executive reported a transfer pricing scheme allegedly intended to evade Colombian tax. The Colombian employer was a third-level subsidiary of Core Laboratories, a Dutch company whose shares were publicly traded on the NYSE and who maintained an office in Texas.

The *Villanueva* tribunal applied a presumption against extraterritoriality derived from *Morrison* and determined that since nothing in Section 806 indicated an intention for the statute to apply extraterritorially, it should not be so applied. This conclusion was reached in spite of Section 929A of the Dodd-Frank Act which makes Section 806(a) of Sarbanes-Oxley applicable to subsidiaries and affiliates included in group consolidated financial statements.

According to the tribunal, it was irrelevant that Core's securities were registered with the SEC and publicly traded on the NYSE, and that Core effectively controlled the third-level Colombian subsidiary with the alleged misconduct reported to Core executives in Houston who ordered the termination of his employment. In the tribunal's view, these factors did not change the foreign nature of the alleged fraudulent conduct and there was not a sufficient connection with the United States. The tribunal found it more compelling that the former CEO was not a US citizen, the employer was not a US company and, importantly, the underlying allegations related to violations by non-US companies of Colombian tax law. The tribunal emphasized the Morrison decision, stating that "even some domestic contact will not convert an extraterritorial application to a domestic one".

The former CEO is expected to appeal the tribunal's decision. If the tribunal's decision is upheld on appeal, it would be an important precedent clarifying the limited application of the whistleblower provisions of the Sarbanes-Oxley Act to foreign companies and their foreign employees.

The *Villanueva v. Core Laboratories NV* US Department of Labor tribunal decision is available at http://www.oalj.dol.gov/PUBLIC/ARB/DECISIONS/ARB_DECISIONS/SOX/09_108.SOXP.PDF.

Absolute Activist Value Master Fund v. Ficeto

In March 2012, the Second Circuit interpreted the *Morrison* ruling by providing guidance on what constitutes a domestic transaction in securities not listed on a US exchange, for the purposes of fraud claims brought under Exchange Act Section 10(b) and Rule 10b-5. The Court held that, for such a securities transaction to be domestic, irrevocable liability must be incurred or title transferred within the United States.

The case concerned purchases by the plaintiffs, several Cayman Islands funds (Funds), of penny stocks in thinly capitalized US companies that registered their shares with the SEC. Such purchases were made on behalf of US investors pursuant to PIPE arrangements executed through the defendants who were US registered broker-dealers acting as placement agents and investment managers. The defendants were engaged in a "pump and dump" scheme and profited from the artificially inflated prices they created by trading in the penny stock shares, in addition to increased placement fees and commission income through the use of a fraudulent BVI investment vehicle. The defendants also engaged in direct marketing activities in the United States and encourage subscriptions from US investors in the fraudulent scheme.

The Circuit Court upheld the judgment of the District Court for the Southern District of New York by affirming in part the dismissal of the complaint for failure to state a claim under Section 10(b). However, mirroring the Supreme Court's analysis in *Morrison*, the Circuit Court disagreed with the District Court's basis of lack of subject matter jurisdiction, stating that the issue of extraterritoriality under Section 10(b) was a merits question. The case was remanded so that the claimants could assert additional facts to suggest that irrevocable liability was incurred or title passed in the United States in respect of the securities transactions.

In determining the location of a securities transaction, the Court found that irrevocable liability was dispositive as corresponding to the point of binding contractual commitment at which a party assumes the obligation to purchase or sell the securities. The Court determined that the alternative location for the transaction would be the place at which the title to the securities passed to the purchaser. The Second Circuit did not find as dispositive the US identity of the issuers or the fact that the penny stock was SEC registered, as it interpreted Morrison's test of "domestic transactions in other securities" to refer to the nature of the transaction and not to the securities themselves. The Court was also not swayed by the citizenship or residency of the purchaser of the securities, or the defendant's US based activities in relation to the securities. Evidence to show the domestic nature of the securities transaction could be presented in the form of subscription agreements, purchase orders, underlying transaction documents, trading records and private placement offering memoranda. While the place of exchange of payment for the securities was deemed relevant, the Court did not find it dispositive that investors in this case had wired purchase monies to a New York bank since the relevant transactions were purchases by the Funds themselves not subscriptions of individual US investors in the Funds.

Absolute Activist is the latest case reflecting the trend established in *Morrison* of limiting the extraterritorial reach of the Exchange Act by narrowly confining the private right of action under Section 10(b) and Rule 10b-5 to so-called "domestic" transactions. It remains to be seen whether the courts will impose further limitations on the territorial scope of applicability of the US federal securities and other laws.

The *Absolute Activist Value Master Fund v. Ficeto* Second Circuit decision is available at http://www.ca2.uscourts.gov/decisions/isysquery/524ed68c-ed12-4e51-86f5-f6b38eab0ddc/1/doc/11-221_opn.pdf#xml=http://www.ca2.uscourts.gov/decisions/isysquery/524ed68c-ed12-4e51-86f5-f6b38eab0ddc/1/hilite/

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