The Supreme Court and Securities Litigation:

Recent Developments and Upcoming Cases

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The Supreme Court decided two important securities fraud cases earlier this year involving statute of limitations issues (*Merck*) and the extraterritorial application of the federal securities laws (*Morrison v. National Australia Bank*). This term the Court will hear two more high-profile securities cases involving issues of when behind-the-scenes defendants can be held civilly liable as participant in a fraud (*Janus*), and what constitutes a "materially misleading" statement under federal law (*Matrixx*).

This memorandum summarizes the history and substance of the Supreme Court's recent decisions in *Merck* and *Morrison,* as well as the important issues presently pending on *certiorari* before the Supreme Court in *Janus* and *Matrixx.*

(1) *Merck & Co. v. Reynolds*, 130 S. Ct. 1784 (2010)

In *Merck*, the Supreme Court resolved a circuit split regarding the proper interpretation of the statute of limitations for Section 10(b) claims.

In 2002, Congress passed the Sarbanes-Oxley Act which (among other things) provided that the statute of limitations for Section 10(b) claims under the Securities Exchange Act of 1934 (the "Exchange Act") would be the earlier of "2 years after the discovery of the facts constituting the violation" or "5 years after such violation." 28 U.S.C. § 1658. Previously, there had been no explicit limitations period for private Section 10(b) claims; instead, under the Supreme Court's decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), courts "borrowed" the limitations period from §9 of the Exchange Act. That period used the same language as §1658, but ran from one year from discovery, or three years from the violation.

The circuits developed different approaches to interpreting the phrase "discovery of the facts constituting the violation." Several circuits interpreted the phrase to mean the earlier of (a) actual discovery of the claim, or (b) when a plaintiff, acting with reasonable diligence, should have discovered the claim. *See, e.g.*, *Law v. Medco Research*, 113 F.3d 781 (7th Cir. 1997). One circuit held that the period began to run when the plaintiff was alerted to the possibility of fraud. *See Theoharous v. Fong*, 256 F.3d 1219 (11th Cir. 2001). Finally, the Second and Third Circuits took a hybrid approach. Once "storm warnings" of a possible fraud were brought to the plaintiff's attention, if the plaintiff investigated her claim the period would run from the earlier of (a) actual discovery the facts constituting the violation, or (b) when she should have discovered such facts in the exercise of reasonable diligence. However, if the plaintiff did not investigate, the period would run from the date of the "storm warnings" – regardless of whether an investigation would have actually revealed the fraud. *See Mathews v. Kidder, Peabody & Co., Inc.,* 260 F.3d 239 (3d Cir. 2001); *LC Capital Partners, LP* v. *Frontier Insurance Group, Inc.*, 318 F.3d 148 (2d Cir. 2003).

In *Merck*, the Supreme Court held that the statute begins to run "once the plaintiff did discover or a reasonably diligent plaintiff would have 'discover[ed] the facts constituting the violation' -- whichever comes first…. irrespective of whether the actual plaintiff undertook a reasonably diligent investigation." *Merck*, 130 S. Ct. at 1798. These "facts" include the "fact" of falsity, and the "fact" of scienter. *See id.* at 1796-97. Critically, the Court indicated that "the facts constituting the violation" are those facts sufficient facts to meet PSLRA pleading standards – including sufficient facts to create a "strong inference" of scienter. *See id.* at 1798 ("The limitations period … lapses two years after a reasonably diligent plaintiff would have discovered the necessary facts. A plaintiff who fails entirely to investigate or delays investigating may well not have discovered those facts by that time or, at least, may not have found sufficient facts by that time to be able to file a §10(b) complaint that satisfies the applicable heightened pleading standards."); *see also id.* at 1796 ("[U]nless a §10(b) plaintiff can set forth facts in the complaint showing that it is 'at least as likely as' not that the defendant acted with the relevant knowledge or intent, the claim will fail. … It would therefore frustrate the very purpose of the discovery rule in this provision … if the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter….").

Beyond making it much harder for defendants to win motions to dismiss on limitations ground, *Merck* suggests that if a claim is dismissed for failure to meet PSLRA pleading standards, and new evidence later comes to light, the plaintiff may be able to amend the complaint (within five years of the violation) and argue that, as a matter of law, her previous failure to meet PSLRA pleading standard demonstrates that she could not have "discovered" the "facts constituting the violation" any earlier -- and that her claim is therefore not time-barred.

Merck explicitly did not decide if the "facts constituting the violation" include facts pertaining to loss, reliance, and loss causation, which are elements of a private claim but not a government action. *See id.* at 1796.

(2) *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010)

Section 10(b) forbids manipulative conduct "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered." 15 U.S.C. §78j(b). In *Morrison*, the Supreme Court for the first time held that §10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." 130 S. Ct. at 2884.

Prior to *Morrison*, the circuits generally applied the "conduct" and "effects" tests to determine the extraterritorial application of §10(b), based on Judge Friendly's landmark decision in *Bersch v. Drexel Firestone, Inc.,* 519 F.2d 974, 985 (2d Cir. 1975) and subsequent Second Circuit precedents. The "conduct" and "effects" tests tended to allow any American resident, and any person who purchased a security in America, to bring an action under §10(b), and American companies were generally subject to suit under §10(b) regardless of where their securities were purchased. However, for claims brought by "foreign cubed" (a/k/a "F-cubed") plaintiffs (namely, foreign plaintiffs who purchased the shares of a defendant foreign company on a foreign stock exchange), results were mixed, with the success of the claims depending on how successful the foreign plaintiff was in showing that the defendant foreign corporation and officers engaged in prohibited conduct in (or purposefully directed at) the territory of the United States.

In *Morrison*, the plaintiffs were Australian nationals who had purchased the "ordinary shares" (the equivalent of "common stock" shares in the U.S.) of National Australia Bank on an Australian exchange. They alleged that an American NAB subsidiary had generated false financial figures that were included in NAB's reported results, and that they suffered losses when the fraud was revealed. NAB's ordinary shares were not traded in America, but its ADRs were traded on the NYSE. No ADR purchasers were included in the putative class.

Justice Scalia, writing for the Court, rejected the entire pre-existing framework for determining the extraterritorial application of §10(b). First, the Supreme Court held that although courts had previously considered the extraterritorial application of §10(b) to be a matter of "subject matter jurisdiction," the issue was actually one of the substantive reach of §10(b), and thus a "merits" question rather than a jurisdictional one. *See* 130 S. Ct. at 2877.

Next, the Court held that when interpreting statutes, there is a generally a presumption "that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States." *Id.* With respect to §10(b), the Court held that there were no such indicators, and that "the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States." *Id.* at 2884. Thus, the Court held that "Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States." *Id.* at 2888.

The decision thus appears to bar traditional F-cubed claims by foreign plaintiffs, and also raises questions as to the extent to which it bars claims by *American* investors who purchased shares of foreign companies on a foreign exchange (so-called "F-squared" purchasers). As noted above, "F-squared" claims brought by U.S. investors were typically permitted under the prior "effects" test, and *Morrison* did not expressly deal with the claims of U.S. purchasers of foreign securities. A number of issues will therefore need to be worked out by the lower courts before we can determine *Morrison's* ultimate scope.

For example, *Morrison* did address the question of whether investors who purchased a security overseas may bring claims when the *same* security is also listed on a domestic exchange. For example, many securities are "dually" listed, *e.g.,* a particular foreign company may allow its ordinary shares to be sold on both a U.S. exchange and on one or more foreign exchanges. Moreover, many foreign corporations also register their ordinary shares on American exchanges as part of the process of creating ADRs – even if those shares are never actually traded. The plain meaning of the rule announced in *Morrison* would suggest that claims based on the purchase of any shares so listed are viable (even though NAB itself had ADRs), because the text of the statute prohibits manipulative conduct "in connection with the purchase or sale of any security *registered* on a national securities exchange or any security not so registered," and *Morrison* specifically held that it was applying the presumption against extraterritoriality *only* to purchases and sales of "any security not so *registered*." *Id.* at 2885 n.10 (emphasis added). Because *Morrison* made clear that it was *not* applying any presumption against extraterritoriality to the phrase "in connection with the purchase or sale of any security registered on a national securities exchange" as used in the Exchange Act, a plain reading of the statute and of Justice Scalia's own words might allow claims based on securities registered domestically, but purchased overseas.

The plaintiffs in the pending *Vivendi* securities class action – which had won a sweeping victory on their securities fraud claims brought on behalf of both US and foreign investors shortly before *Morrison* was decided -- have filed a brief arguing that even though only Vivendi's ADRs *traded* on the NYSE, its ordinary shares were *listed and registered* (although not traded) on the NYSE. Accordingly, the *Vivendi* plaintiffs have argued that §10(b) permits claims based on purchases of its ordinary shares, wherever those transactions occurred. The court has not yet ruled, but a similar argument was recently rejected by Judge Marrero in *In re Alstom SA Sec. Litig.*, No. 1:03-cv-06595, slip op. (S.D.N.Y. Sept. 14, 2010), on the ground that *Morrison*'s reasoning suggests that §10(b) is only concerned with "domestic" purchases and sales.

Interestingly, although *Morrison* expressly states that "domestic transactions" in securities (as well as transactions in securities "listed" with a US exchange) are within the scope of Section 10(b), the Supreme Court did not discuss what it means to purchase a security in a "domestic transaction." Justice Stevens, concurring in the judgment, suggested that the phrase might well be interpreted narrowly: he objected to the majority's rule in part on the ground that it might bar claims where executives of an overseas company "go knocking on doors in Manhattan and convince an unsophisticated retiree, on the basis of material misrepresentations, to invest her life savings in the company's doomed securities." *Id.* at 2895. But nothing in the majority opinion discusses whether, for example, a purchase may be deemed to be "domestic" if it is solicited in the U.S., and/or placed through a U.S. broker or through U.S. instrumentalities of commerce. To date, courts have generally held that even if the order is placed from the U.S., §10(b) does not cover purchases of securities on foreign exchanges. *See*, *e.g.*, *Cornwell v. Credit Suisse Group,* 2010 U.S. Dist. LEXIS 76543 (S.D.N.Y. July 27, 2010); *Stackhouse v. Toyota Motor Co*, 2010 U.S Dist. LEXIS 79837 (C.D. Cal. July 16, 2010). But, in *Anwar v. Fairfield Greenwich, Ltd.*, 2010 U.S. Dist. LEXIS 86716 (S.D.N.Y. Aug. 18, 2010), which involved purchases of shares in an offshore hedge fund, Judge Marrero held that the record required further factual development to determine where the "purchases" actually occurred. And Judge Marrero also left open the question of whether investors who purchased Alstom's ordinary shares directly from the Company and/or its underwriters pursuant to SEC-registered offering materials have Section 10(b) claims, even if the shares themselves did not subsequently trade on a US exchange. *In re Alstom SA Sec. Litig.*, No. 1:03-cv-06595, slip op. (S.D.N.Y. Sept. 14, 2010).

Morrison also raises the possibility that plaintiffs will seek to craft alternative remedies to Section 10(b) on behalf of their clients, including through the pleading of state or foreign law fraud claims in appropriate cases.

(3) ***Janus Capital Group, Inc. v. First Derivative Traders, No.09-525*** (currently pending before the Supreme Court)

Section 10(b) of the Exchange Act makes it unlawful for "any person, directly or indirectly … [t]o use or employ, in connection with the purchase or sale of any security … any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe …." 15 U.S.C. §78j(b). The Supreme Court recently granted certiorari to decide whether private plaintiffs may bring lawsuits under §10(b) against persons or entities who did not themselves issue false statements, but who participated in drafting the false statements before they were formally issued by others.

In *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), the Supreme Court held that §10(b) imposes private civil liability only on those who engage in manipulative or deceptive conduct, but does *not* impose such liability on those who merely "aid and abet" such conduct. Because the plaintiff in that case conceded that the defendant had only "aided and abetted" the primary violator, the Court did not discuss the difference between engaging in deceptive conduct, and mere aiding and abetting. *See id.* at 191-92.

The Supreme Court revisited the issue in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). There, the plaintiffs alleged that certain vendors of cable boxes had intentionally engaged in sham transactions with a cable company in order to allow the cable company to inflate its reported revenues. The Supreme Court held that the vendors had done no more than "aid and abet" the cable company's fraud because the causal connection between the vendors' conduct and the false statements ultimately issued by the cable company was too attenuated. As the Supreme Court put it, "nothing respondents did made it necessary or inevitable for [the cable company] to record the transactions as it did." 552 U.S. at 161.

After *Central Bank*, and, later, *Stoneridge*, courts struggled to distinguish "primary" from "secondary" violations of the securities laws, and their decisions are wildly inconsistent. Generally, courts have varied on two questions: (1) what constitutes "making" a statement when the person who drafts, or participates in drafting, the statement is not the same person who distributes it, and (2) whether the investing public must actually know the identity of the drafter before the element of reliance in a §10(b) action is satisfied.

In *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615 (9th Cir. 1994) and *Howard v. Everex Sys. Inc.*, 228 F.3d 1057 (9th Cir. 2000), the Ninth Circuit held that liability would be imposed so long as the defendant played a significant role in drafting the misleading statements. Nothing in the Ninth Circuit's rule (decided pre-*Stoneridge*) suggests that the investor must know the identity of the drafter before he or she can satisfy the element of reliance.

The Second Circuit, by contrast, has suggested that an actor has neither made a statement, nor has an investor relied upon the actor's conduct, unless the statement is explicitly attributed to the actor at the time of dissemination, most recently in the Refco case, *see Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) ("*PIMCO*"), but also in *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998). Some portions of the opinion discuss the need for attribution as a function of the need to establish reliance – *see* 603 F.3d at 156 ("Where statements are publicly attributed to a well-known national law or accounting firm, buyers and sellers of securities (and the market generally) are more likely to credit the accuracy of those statements.") – while other portions suggest that absent attribution, the behind-the-scenes drafter has not "made" a statement and thus has not engaged in deceptive conduct. *See id.* ("Public understanding that [a secondary actor] is at work behind the scenes does not create an exception to the requirement that an actionable misstatement be made by the [secondary actor]" (quoting *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 155 (2d Cir. 2007)).

Other circuits have adopted divergent approaches. For example, the Tenth Circuit requires that the behind-the-scenes actor actually draft the false statement – substantial participation is not sufficient – but does not require attribution. *See Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (10th Cir. 1996); *SEC v. Wolfson*, 539 F.3d 1249, 1259 (10th Cir. 2008) ("We have never adopted an attribution requirement in a private securities case…."). The Sixth Circuit has suggested that if one actor supplies false information to another for public distribution, liability will attach, even without attribution. *See City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2005). The Seventh Circuit, after *Stoneridge*, held that plaintiffs could not satisfy the element of reliance where executives of a subsidiary corporation supplied false information to the parent corporation for inclusion in the parent's public financial statements. *See Pugh v. Tribune Co.*, 521 F.3d 686 (7th Cir. 2008).[1]

In *Janus*, the plaintiffs allege that an asset management firm, Janus Capital Group (JCG), and its wholly owned subsidiary, Janus Capital Management (JCM), drafted misleading prospectuses on behalf of the mutual funds administered by JCM. The Fourth Circuit held that even though the prospectuses did not explicitly state that they were drafted by either JCG or JCM, knowledgeable investors would have understood that such prospectuses are often drafted by the fund's administrator rather than the funds themselves, and thus would have correctly identified JCM as the true drafter. On this basis, the Fourth Circuit permitted the plaintiffs' claims to proceed against JCM. However, the court held that investors would not have understood that the parent company, JCG, had been involved in drafting the prospectuses, and therefore dismissed the §10(b) claims against JCG. *See In re Mutual Funds Inv. Litig.*, 566 F.3d 111 (4th Cir. 2009).

The Supreme Court granted cert in *Mutual Funds* (under the name *Janus Capital Group, Inc. v. First Derivative Traders*), to resolve the circuit split and to determine the extent to which a person or entity must be involved in drafting false statements to trigger §10(b) liability. If the Supreme Court holds that JCM is immune from private liability, the disincentives for "outside parties" – including dishonest attorneys, auditors, underwriters and other professional "gatekeepers" – to participate in such frauds in the future will be sharply diminished. However, if the Court holds that such persons and entities are subject to liability (provided that the relevant heightened pleading burdens under the PSLRA are met), the potential for further frauds (such as those in *Refco* and *Mutual Funds*) will be reduced.

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[1] Where the behind-the-scenes drafter is an employee of the corporation itself (rather than an affiliated but separate corporate entity), courts have historically agreed that both the corporation and its employee will be liable for supplying false information to stock market analysts, even if the analyst did not specifically attribute that information to the corporation. *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000); *Southland Secs. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 373 (5th Cir. 2004); *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 743 (8th Cir. 2002); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1428 (3d Cir. 1997); *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997).

(4) ***Matrixx Initiatives, Inc., v. Siracusano, No. 09-1156*** (currently pending before the Supreme Court)

To state a securities fraud claim, plaintiffs must allege that a defendant omitted or misstated a "material" fact in connection with the purchase or sale of securities. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005). A fact is material if there is 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." *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). The question of materiality is generally considered one particularly suited for the trier of fact, and accordingly motions to dismiss for failure to adequately allege materiality are generally difficult for defendants to win. *See, e.g., Ganino v. Citizens Utils. Co.*, 228 F.3d 154 (2d Cir. 2000).

The Supreme Court granted certiorari in *Matrixx* to determine whether "adverse event reports" associated with a particular drug may be considered "material" absent a showing that the number of adverse events is statistically significant relative to sales of the drug.

Prior to *Matrixx*, some appellate decisions suggested that statistical significance would be necessary to demonstrate materiality in the context of securities fraud cases against drug manufacturers accused of making false or misleading statements concerning their products. For example, in *In re Carter-Wallace, Inc. Securities Litigation*, 220 F.3d 36 (2d Cir. 2000), plaintiffs alleged that the defendant company unreasonably delayed disclosing that its drug caused aplastic anemia. The sole basis for this claim was the allegation that the company had received a "statistically unacceptable" number of adverse reports linking the drug to some adverse medical condition or disease (one of which was aplastic anemia). The Second Circuit held that such data did not render defendants' statements regarding the drug's safety false absent allegations that there were a statistically significant number of adverse reports linking the drug to aplastic anemia specifically. Similarly, in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000), the Third Circuit placed some weight on the fact that the plaintiffs failed to show that the number of adverse reports were statistically significant, although in that action the defendant company had also expressly warned that the data regarding the drug's safety were "inconclusive" – leading the court to hold that absent statistical significance, undisclosed adverse reports did not render the company's statements false.

In *Matrixx*, the plaintiffs alleged that the defendant pharmaceutical company had received different types of information, including, but not limited to, numerous adverse reports, suggesting that its cold remedy drug caused a loss of the sense of smell. Despite this information, the company continued to insist that its drug was safe. The district court dismissed the plaintiffs' claims on the ground that they had failed to show that the number of adverse event reports of this effect was statistically significant, and therefore failed to show that the defendants had misrepresented or omitted any "material" facts about the drug. On the same grounds, it also held that the plaintiffs had failed to show that the defendants had acted with scienter in failing to disclose the reports.

The Ninth Circuit reversed. Characterizing materiality as a "fact-specific inquiry," it held that the allegations of numerous adverse event reports, together with the other information that was allegedly known to defendants (such as studies linking a key ingredient of the drug to the loss of a sense of smell), was sufficient to render the plaintiffs' claims of materiality "plausible," and hence sufficient at the pleading stage. *Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d 1167 (9th Cir. 2009).

The Supreme Court granted certiorari to address the issue of when undisclosed adverse event reports can provide the basis of a securities fraud claim. The defendants argue both that the Court should apply a bright-line rule of materiality requiring statistical significance, and, in a lesser but related point, that absent a showing of materiality via statistical significance, plaintiffs cannot demonstrate scienter.

Since *Basic* was decided, courts have eschewed creating "bright-line" tests for materiality, and have instead followed the Supreme Court's instruction to decide materiality based on the particular mix of facts presented and the nature of the defendants' allegedly false representations. *See, e.g.*, *Ganino*, 228 F.3d at 162-63; *Mississippi Pub. Employees' Ret. Sys. v. Boston Scientific*, 523 F.3d 75, 87 (1st Cir. 2008); *Martinez v. Schlumberger, Ltd.*, 338 F.3d 407 (5th Cir. 2003). As the Supreme Court itself explained in *Basic*, "Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over- or underinclusive… The [SEC's] Advisory Committee on Corporate Disclosure cautioned the SEC against administratively confining materiality to a rigid formula. Courts also would do well to heed this advice." *Basic*, 485 U.S. at 236.

Thus, although the issue in *Matrixx* may seem to have limited application, the case represents the first time that the Court will consider the definition of "materiality" since *Basic*, and the possibility exists that the Court will begin to trim the expansive materiality standard that has been a staple of securities litigation for 20 years. If the Court indicates that it is receptive to new bright-line materiality rules, lower courts may begin to generate them in other contexts.