RECENT DEVELOPMENTS AND TRENDS IN SECURITIES LITIGATION

Seth Aronson
Dhaivat H. Shah
Roberta H. Vespremi

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O'Melveny & Myers LLP

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I. Introduction

2008 and 2009 have seen the continued upwards trend of securities class action filings that began in 2007. There were 210 federal securities class actions filed in 2008, an increase of 29% over 2007.[1] In the first two quarters of 2009, there were over 85 class actions filed.[2] If this trend continues, there will be over 170 securities class action filings in 2009, consistent with the average pace of 182 filings per year since the enactment of the Private Securities Litigation Reform Act of 1995 (the "Reform Act").[3]

The trend resulted in large measure from the continued upsurge of securities class actions related to the worldwide financial crisis, including the subprime mortgage meltdown. In 2008, there were a total of 98 actions filed directly related to the financial crisis, roughly 47% of the total securities class actions filed.[4] For the first time since the enactment of the Reform Act, the plaintiffs' bar filed more class actions against the financial services industry than any other industry.[5] An emerging subset of

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[1] PriceWaterhouseCoopers, *2008 Securities Litigation Study* at 6, *available at* http://10b5.pwc.com/PDF/NY-09-0894%20SECURITIES%20LIT%20STUDY%20FINAL.PDF (last visited June 11, 2009).

[2] Stanford Law School Securities Class Action Clearinghouse, Securities Class Action Filings, http://securities.stanford.edu/fmi/xsl/SCACPUDB/recordlist.xsl (last visited July 2, 2009). Note, however, that in June 2009 only 6 securities class actions were filed, which is the lowest monthly filing total since December 1996, when 5 cases were filed. Ben Hallman, *Oh Securities Class Actions, Where Art Thou?*, The AmLaw Litigation Daily (July 1, 2009), *available at*: http://www.law.com/jsp/tal/digestTAL.jsp?id=1202431933348&Oh_Securities_Class_Actions_Where_Art_Thou (last visited July 2, 2009). Commentators speculate that this downturn will be temporary, and that it is due to two main factors: (1) the large amount of Madoff-related litigation and (2) the vast quantity of subprime and credit crisis-related litigation filed previously that are now just reaching "critical procedural stages." *Id.*

[3] PriceWaterhouseCoopers, *supra* note 1, at 6.

[4] *Id.* at 8.

[5] *Id.* at 5.

the financial crisis cases and government investigations is related to auction rate securities. The SEC reached record-breaking settlements with firms charged with misleading investors about the liquidity risks associated with auction rate securities that they underwrote, marketed and sold.

The number of back-dated stock-option-related securities class actions, by contrast, fell dramatically. Only four actions were filed in 2008, and none in the first two quarters of 2009.[6] This fall off is not surprising, as the stock options news scandal broke in 2006, and most filings occurred soon thereafter.

There were several other trends of note in 2008-09. The number of accounting-related securities class actions fell to the lowest numbers since the passage of the Reform Act —comprising 40% of cases filed in 2008.[7] The number of settlements in 2008 fell to the lowest number in the past ten years—for a total of 95 settlements compared with 121 in 2007.[8] Finally, there were 36 securities class actions filed against foreign private issuers in 2008, a 33% increase over 2007.[9] Over half of these matters were related to the financial crisis, with the bulk of foreign companies affected being Canadian companies.[10]

Other interesting developments this year included the Bernard Madoff scandal that broke open in December 2008, quite possibly the largest Ponzi scheme ever, with loss estimates reaching $50 billion.[11] Further, the United States passed the Emergency Economic Stabilization Act of 2008, "which recommitted to repurchase toxic assets and recapitalize certain financial institutions. . . . [T]he overall federal resources

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[6] Stanford Law School Securities, Class Action Clearinghouse, Securities Class Action Filings, http://securities.stanford.edu/litigation_activity.html (last visited June 14, 2009).
[7] PriceWaterhouseCoopers, *supra* note 1, at 9.
[8] *Id.* at 18.
[9] *Id.* at 5.
[10] *Id.*
[11] *Id.* at 3.

committed in 2008 to support the financial markets, housing, and financial institutions has been estimated to exceed $6.4 trillion."[12]

It is against the backdrop of these trends and the exploding financial crisis that we examine significant recent developments in securities litigation. First, the legal landscape continues to develop around the 2007 Supreme Court cases of *Bell Atlantic Corp. v. Twombly* (antitrust)[13] and *Tellabs, Inc. v. Makor Issues & Rights, Ltd*,[14] where the Court ruled that plaintiffs must plead a plausible factual basis for relief and a cogent and compelling inference of fraudulent intent to satisfy the pleading requirements. Second, the Ninth Circuit has issued a number of opinions construing *Tellabs* against the core operations inference. Third, the Ninth Circuit provided additional clarity on the requirements for pleading loss causation. Fourth, the Fifth Circuit further addressed the requirements of loss causation at the class certification stage. Fifth, the article addresses the Ninth Circuit's most recent opinion on the collective scienter doctrine. Sixth, the Eleventh Circuit recently ruled that companies settling securities class actions can include bar orders under the Reform Act that extinguish their former officers' statutory and contractual rights to advancement and indemnification of legal fees. Seventh, the U.S. Supreme Court recently granted certiorari to settle the question of when an investor is put on inquiry notice of fraud for the purposes of starting the statute of limitations clock for Section 10(b) actions. Finally, this article discusses some of the recently reported decisions from subprime mortgage securities class actions and an update on pending stock options cases.

[12] PriceWaterhouseCoopers, *supra* note 1, at 3.
[13] 550 U.S. 544 (2007).
[14] 551 U.S. 308 (2007).

II. Developments in Pleading Standards for Securities Actions

Several significant Supreme Court decisions have been issued in recent years that help define the pleading standards for securities class actions under the Reform Act.

In *Bell Atlantic v. Twombly*,[15] plaintiffs in an antitrust class action alleged that the incumbent local exchange carriers ("ILEC") that emerged from the 1984 divestiture of AT&T's local telephone business engaged in anti-competitive conduct by failing to compete in one another's markets and by engaging in parallel conduct within their own markets to prevent entry by competitive local exchange carriers ("CLEC"). The district court held that plaintiffs failed to state a claim under section 1 of the Sherman Act because the alleged parallel business conduct of the ILECs did not show that they had entered into a conspiracy and that their conduct was fully explained by their independent self-interest in defending their territory. The district court further held that plaintiffs were required to allege additional facts that excluded independent self-interest as the basis for the ILECs' conduct. The Second Circuit reversed on the ground that plaintiffs' allegations must be deemed sufficient unless there was "no set of facts that would permit a plaintiff to demonstrate that the particular parallelism asserted was the product of collusion rather than coincidence."[16]

Justice Souter, writing for the majority, held that while allegations of parallel conduct showed that it was "conceivable" that there was a conspiracy, plaintiffs had not alleged sufficient facts showing that defendants had acted collusively rather than in their independent self-interest to "nudge[] their claims across the line from conceivable to plausible."[17] The Court held that, without more, allegations of parallel conduct did not state a claim for an antitrust conspiracy under Section 1 of the Sherman Act.

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[15] 550 U.S. 544.
[16] *Id.* at 551 (citation and internal quotation marks omitted).
[17] *Id.* at 570.

Twombly has ramifications that extend beyond pleading requirements for antitrust conspiracy. The Court held that the notice pleading standard under Rule 8 of the Federal Rules of Civil Procedure was not satisfied by "labels and conclusions" and that "[f]actual allegations must be enough to raise a right to relief above the speculative level."[18] It overruled the longstanding formulation in *Conley v. Gibson*[19] that a complaint cannot be dismissed on the pleadings "'unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim.'"[20] Instead, a plaintiff must plead facts showing a plausible entitlement to relief.

The requirement that a plaintiff show a plausible entitlement to relief is particularly important in the class action context where a plaintiff could otherwise abuse the discovery process by imposing significant burden and cost where there was little likelihood that discovery would lead to facts supporting plaintiff's claims. The *Twombly* Court stated that it was the same concern with the *in terrorem* effect of discovery that led to the Court's requirement in *Dura Pharmaceuticals, Inc. v. Broudo*,[21] that plaintiffs be required to plead loss causation in securities class actions.[22]

Justice Stevens wrote the dissenting opinion with Justice Ginsburg joining. Justice Stevens argued that the majority requirement of pleading factual plausibility was inconsistent with the federal notice pleading regime under Rule 8, which requires only notice of the claim without a need to plead detailed evidentiary facts.[23] Justice Stevens further argued that any concerns about permitting discovery on the basis of speculative allegations may be addressed by "careful case management."[24]

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[18] *Id.* at 555.
[19] 355 U.S. 41 (1957).
[20] 550 U.S. at 560 (quoting *Conley*, 355 U.S. at 45-46).
[21] 544 U.S. 336 (2005).
[22] 550 U.S. at 556.
[23] *Id.* at 579-82.
[24] *Id*. at 572.

Although *Twombly* involved an antitrust claim, lower courts expressly applied the "plausibility" pleading standard of *Twombly* to securities complaints.[25] This approach was recently validated by the Supreme Court by the majority opinion issued in *Ashcroft v. Iqbal*.[26] In *Ashcroft*, a plaintiff prisoner that brought a civil claim for unconstitutional discrimination against a number of federal officials argued that the *Twombly* pleading standard was limited to antitrust cases.[27] The Supreme Court rejected this argument and held that the *Twombly* standard applied to "all civil actions."[28] The *Ashcroft* opinion made clear that lower courts should conduct a two-pronged analysis of all civil claims. First, they should identify all allegations in a complaint that are conclusory and therefore should be given no weight. Second, it should take the remaining factual allegations and determine whether they give rise to a plausible entitlement to relief.[29]

The *Twombly* and *Ashcroft* opinions may affect how courts evaluate securities claims in two respects. First, they may enhance the scrutiny that courts apply to the "falsity" element of a securities claim brought under Section 10(b). While plaintiffs' allegations regarding falsity must be accepted as true, *Twombly* and *Ashcroft* require that plaintiffs allege a quantum of evidentiary facts such that plaintiffs' allegations are also plausible. Of course, plaintiffs must also satisfy the qualitative requirements under Rule 9(b) and the Reform Act that they allege falsity with particularity. Second, *Twombly* and *Ashcroft* may heighten the pleading requirements in cases brought under Rule 11 or Rule 12 of the Securities Act of 1933. Those claims generally are not subject to the heightened pleading requirements of the Reform Act or Fed. R. Civ. P. 9(b) when they do not "sound in fraud."[30] The plausibility thresholds

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25 *E.g.*, *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 n.2 (2d Cir. 2007); *TCS Capital Mgmt., LLC v. Apax Partners, LP*, No. 06-CV-13447 (CM), 2008 WL 650385, at *13 (S.D.N.Y. Mar. 7, 2008); *Garcia v. Santa Maria Resort, Inc.*, 528 F. Supp. 2d 1283, 1288 (S.D. Fla. 2007).

26 129 S. Ct. 1937 (2009).

27 *Id*. at 1953.

28 *Id.*

29 *Id*. at 1950.

30 *See, e.g., In re Daou Sys., Inc.*, 411 F.3d 1006, 1027 (9th Cir. 2005).

of *Twombly* and *Ashcroft* heighten the pleading requirements of the Rule 8 standard by which these claims should be judged.

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,*[31] the Supreme Court clarified how to evaluate competing inferences when determining whether plaintiffs have satisfied the Reform Act's requirement that they plead facts giving rise to a strong inference of scienter.

In *Tellabs*, plaintiffs alleged that Richard C. Notebaert, chief executive officer of Tellabs, Inc., made false and misleading statements about the financial health of the fiber-optics network company. Judge Posner, writing for the Seventh Circuit, concluded that plaintiffs' allegations gave rise to a strong inference of scienter under the Reform Act. In Judge Posner's view, the Reform Act required only that a plaintiff allege "facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." Judge Posner ruled that a "reasonable person" could infer from the statements that "Notebaert knew that his statements were false."[32]

The Supreme Court reversed, with Justice Ginsburg writing the majority opinion. The Court noted that "[e]xacting pleading requirements are among the control measures Congress included in the [Reform Act]" as a "check against abusive litigation."[33] The Court also noted that Congress left the key term – "strong inference" – undefined and that "[t]o qualify as 'strong' within the intendment of §21D(b)(2), . . . an inference of scienter [*i.e.* fraudulent intent] must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[34] Justice Ginsburg explained that a "court must take into account plausible opposing inferences" because "[t]he strength of an inference cannot be decided in a vacuum."[35] The Court further held that in assessing

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[31] 551 U.S. 308.
[32] *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602-03 (7th Cir. 2006).
[33] 551 U.S. at 313.
[34] *Id.* at 313-14.
[35] *Id.* at 321-23.

whether a plaintiff's allegations satisfy these standards, "omissions and ambiguities count against inferring scienter."[36]

Justice Scalia, in his concurring opinion, disagreed with the Court's conclusion that a plaintiff has satisfied his pleading burden where he alleges facts giving rise to plausible inference in favor of scienter that is equal to a plausible inference against scienter. In Justice Scalia's view, a plaintiff could only plead a "strong" inference of scienter where the inference of scienter was greater than any opposing inference.[37] Justice Alito, in his concurring opinion, agreed with Justice Scalia's view and also disagreed with the Court's statement that ambiguities in plaintiff's allegations only reduce their weight in creating an inference of scienter. Justice Alito argued that allegations that lack sufficient particularity should be given no weight.[38]

Justice Stevens dissented. He credited the majority with developing a "perfectly workable definition" of the meaning of a strong inference of scienter, but argued that a "probable cause" standard "would be both easier to apply and more consistent with the statute."[39] Justice Stevens argued that because the complaint contained allegations from 27 confidential witnesses, viewed collectively they establish "probable cause" of Mr. Notebaert's fraudulent intent without the need to weigh competing inferences.[40]

Tellabs has several revealing features. First, the Court is seriously concerned about "frivolous, lawyer-driven litigation."[41] The Court recognizes that private securities fraud actions "if not adequately contained can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law."[42] Second, the Court took an important step in the name of Congress, purporting simply to interpret the

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[36] *Id.* at 325.
[37] *Id.* at 328.
[38] *Id.* at 333.
[39] *Id.* at 335.
[40] *Id.*
[41] *Id.* at 322.
[42] *Id.* at 313.

statutory phrase "strong inference." This feature of the dispute makes the decision somewhat easier to write, doctrinally, than *Twombly* where there was no special statutory construction directly in play. (This distinction might reconcile Justice Ginsburg's dissent in *Twombly* and her majority opinion here). Third, Justice Scalia's and Alito's concurrences advocate an even tougher "more likely than not"[43] standard for proving fraudulent intent. Justice Stevens' dissent notes that the majority decision is "perfectly workable."[44] There is little real disagreement on the Court about the need for tightening pleading requirements.

The Seventh Circuit opinion in *Higginbotham v. Baxter International, Inc.* was one of the first rulings to apply the *Tellabs* standard.[45] *Higginbotham* arose from lawsuits filed after Baxter International announced that it would need to restate the preceding three years' earnings to correct errors created by fraud at a subsidiary in Brazil. The most noteworthy aspect of this opinion was that the Seventh Circuit concluded that *Tellabs* significantly weakened plaintiffs' use of "confidential witnesses" in a securities complaint because "[i]t is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences."[46] The court said that it was possible to imagine situations where statements from anonymous sources could "corroborate or disambiguate evidence from disclosed sources," but that such allegations should be steeply discounted in assessing whether they support an inference of scienter.[47]

The Seventh Circuit had occasion again to consider the pleadings in the Tellabs complaint on remand from the Supreme Court in *Makor Issues & Rights, Ltd. v. Tellabs Inc.* ("Tellabs II").[48] Judge Posner again wrote for the Circuit Court. Although the Seventh Circuit recognized that *Tellabs* instructs courts first to evaluate if the inference of fraud is cogent, and then perform a

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[43] *Id.* at 333.
[44] *Id.* at 335.
[45] 495 F.3d 753 (7th Cir. 2007).
[46] *Id.* at 757.
[47] *Id.*
[48] 513 F.3d 702 (7th Cir. 2008).

comparative analysis of opposing inferences, the Seventh Circuit ruled that it was "easier" to perform the comparative analysis first.[49] Tellabs allegedly made false and misleading statements regarding demand for its flagship products. The Circuit Court found that the inference that senior management acted with fraudulent intent in connection with alleged false and misleading statements regarding Tellabs's flagship products was "*much* more likely" than that senior management was unaware that these statements were untrue.[50] The Circuit Court further held that because the inference of scienter was much stronger than any opposing inference, it was by definition "cogent." The Circuit Court reasoned that the "plausibility of an explanation depends on the plausibility of the alternative explanations" and that "[a]s more and more alternatives to a given explanation are ruled out, the probability of that explanation's being the correct one rises."[51] The Seventh Circuit's formulation may reach the correct result in most cases. The risk of this approach, however, is that in some instances the allegations may be insubstantial and may give rise to a weak inference of scienter that is nevertheless stronger than a weak opposing inference.

One other noteworthy aspect of the *Tellabs II* opinion is that the Seventh Circuit again visited the use of confidential witnesses in securities complaints. The Seventh Circuit noted the "seeming flimsiness of the asserted need for anonymity" and reiterated that allegations based on confidential witnesses were difficult to assess. Unlike the complaint in *Higginbotham*, however, the Seventh Circuit in *Tellabs II* found that plaintiffs' confidential witnesses were numerous, and that their positions and access to information were described with particularity and the information they obtained was described in convincing detail.[52] Based on the *Higginbotham* and *Tellabs II* opinions, it appears the use of confidential witnesses has been weakened by *Tellabs* but that these allegations may still carry some weight where plaintiffs make a convincing showing that they are reliable.

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[49] *Id.* at 707.
[50] *Id.* at 710.
[51] *Id.* at 710-11.
[52] *Id.* at 711-12.

In an effort to make the best of a bad situation, some plaintiffs' lawyers have attempted to characterize the Supreme Court's *Tellabs* decision as plaintiff-friendly. They cite the language from the opinion that the inference of scienter "need not be irrefutable," *i.e.*, of the "smoking gun" genre, or even the "most plausible of competing inferences" so long "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference."[53] Plaintiffs argue that this sets a low burden because they need only show that the defendants were as likely to have acted with scienter as not. This ignores the first prong of the scienter analysis, *i.e.*, do the facts give rise to ***cogent*** inference of scienter? Courts construing *Tellabs* have noted that the word "'cogent . . . means compelling or convincing.'"[54] A weak inference of scienter will not satisfy this standard even if the opposing inference is equally weak because the inference of scienter will not be cogent.

The natural corollary to this question is what happens where there is a "tie?" What if the allegations give rise to a strong inference of fraudulent intent, and an equally strong opposing inference? Under the plain text of *Tellabs*, where the inference of scienter is both cogent and "at least as compelling as any opposing inference," plaintiff has satisfied his burden.[55] Courts interpreting *Tellabs* have confirmed that "where there are equally strong inferences for and against scienter, *Tellabs* now awards the draw to the plaintiff," and thereby reduces the pleading burden in those circuits, such as the First Circuit, where courts previously required plaintiffs to establish that the inference of scienter was stronger than any opposing inference.[56] While the decision goes to the plaintiff where there are two equally strong inferences, it should be noted that the circumstances under which this will occur will be

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[53] 551 U.S. at 323 (citation and internal quotation marks omitted).
[54] *In re Top Tankers, Inc. Sec. Litig.*, 528 F. Supp. 2d 408, 415 (S.D.N.Y. 2007) (quoting *Black's Law Dictionary* 252 (7th ed. 1999)).
[55] 551 U.S. at 323.
[56] *ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 F.3d 46, 59 (1st Cir. 2008); *see also Mississippi Pub. Employees' Ret. Sys. v. Boston Scientific Corp.*, 523 F.3d 75, 89-90 (1st Cir. 2008); *In re Top Tankers, Inc. Sec. Litig.*, 528 F. Supp. 2d at 413-14.

rare. As Justice Scalia noted in his *Tellabs* dissent: "How often is it that inferences are precisely in equipoise?"[57]

III. Post-*Tellabs* – The Core Operations Inference

Several recent post-*Tellabs* opinions do not discuss the weighing of inferences so much as the inference to be drawn of the knowledge of senior executives regarding potentially catastrophic risks of harm to the company. In *Berson v. Applied Signal Technology, Inc.*, plaintiffs brought an action against the company and two officers under Section 10(b) and Rule 10b-5 after Applied Signal announced that its revenue fell 25%, which in turn caused its stock price to drop 16%.[58] Applied Signal's customers are nearly all federal government agencies who have the ability to issue "stop work orders" on existing contracts at any time. A "stop work" order can result in the work being cancelled altogether.[59] Plaintiffs alleged that Applied Signal's practice of categorizing stopped work as backlog was misleading because Applied Signal knew that there was a heightened risk that the work could be cancelled entirely, and that the company would lose the revenue forever.[60]

The Ninth Circuit determined that plaintiffs alleged facts that gave rise to a strong inference of scienter because Applied Signal's CEO and CFO knew that prior stop work orders resulted in the cancellation of "significant amounts of work, yet counted the stopped work as backlog anyway."[61] In reaching this conclusion, the court noted that even though the plaintiffs did not allege that the CEO and CFO had knowledge of the stop work orders in question, it was appropriate to infer that the CEO and CFO "must have known" about them because of the "devastating effect on the corporation's revenue."[62] The Ninth Circuit cited to *No. 84 Employer-Teamster Joint Council Pension Trust Fund v.*

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[57] 551 U.S. at 330.
[58] No. 06-15454, 2008 U.S. App. LEXIS 19982, at *1-2 (9th Cir. June 5, 2008).
[59] *Id.*, at *2.
[60] *Id.*, at *3.
[61] *Id.*, at *12.
[62] *Id.*

America West Holding Corp.[63] in support of its discussion of scienter, and noted that it had approved "a similar inference" in that case.[64]

The Ninth Circuit stated that it drew an inference of scienter in *America West* against certain "outside directors" because airplane maintenance problems and the FAA's investigation into them were so important to the airline that it was "absurd to suggest that the Board of Directors would not discuss them."[65] The court found the inference here to be stronger than that in *America West* because the CEO and CFO were responsible for the company's "day-to-day operations," whereas the *America West* defendants "were outside directors who did no more for the company than attend board meetings and serve on a board committee," and thought it was "hard to believe that [Applied Signal's CEO and CFO] would not have known about stop-work orders that allegedly halted tens of millions of dollars of the company's work."[66] The court followed this line of logic stating that "[i]f plaintiffs in *America West* could rely on an inference that outside directors were aware of maintenance problems over which they had no direct management responsibility, then plaintiffs here are entitled to rely on a similar inference as to the four stop-work orders."[67] The Ninth Circuit found that the plaintiffs had met the requisite pleading standards, and reversed the lower court's dismissal of the case.[68] The lesson of *Berson* and *America West* may be that under certain narrow circumstances a court in the Ninth Circuit may infer that senior executives knew of bet-the-company types of events even if plaintiffs fail to plead facts specifically showing that they were aware of these events.

Indeed, another panel of the Ninth Circuit recently described the *Berson* case as being in an "exceedingly rare category of cases in which the core operations inference, without more, is sufficient under the PSLRA" but that "[a]s a general

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[63] 320 F.3d 920 (9th Cir. 2003).
[64] 2008 U.S. App. LEXIS 19982, at *12.
[65] *Id., at* *12 (citation and internal quotation marks omitted).
[66] *Id., at* *13.
[67] *Id.*, at *13-14.
[68] *Id.*, at *19-20.

matter, 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 allegation of specific information conveyed to management and related to the fraud."[69]

South Ferry is an important case in the line of decisions construing *Tellabs,* because it holds that prior Ninth Circuit precedent may have "focused too narrowly" on the viability of individual scienter allegations and that "*Tellabs* counsels us to consider the totality of circumstances."[70] *South Ferry* applied this "thematic idea" from *Tellabs* to the "core operations" theory of scienter, *i.e.*, the theory that a court may infer that the "facts critical to a business's 'core operations' or an important transaction are known to a company's key officers."[71] The Ninth Circuit held that while such allegations are generally not sufficient of themselves to show a strong inference of scienter, where they are accompanied by particularized allegations showing that defendants "had actual access to the disputed information," they may be sufficient to satisfy the pleading standard.[72] Moreover, even where "core operations" allegations are not accompanied by particularized allegations of actual access by management and therefore are insufficient to give rise to a strong inference of scienter, a court may nevertheless consider these allegations in its assessment of whether the collective allegations of the complaint satisfy the scienter pleading requirement.[73]

More recently, in *Zucco Partners, LLC v. DigiMarc Corporation*[74], the Ninth Circuit again affirmed that plaintiffs are bound by prior Ninth Circuit decisions relating to the particularity requirement in pleading scienter. As the court in *Zucco Partners* stated, "*Tellabs* does not materially alter the particularity requirements for scienter claims established in our previous

[69] *South Ferry LP v. Killinger*, -- F.3d --, No. 06-35511, 2008 WL 4138237, at *5 (9th Cir. Sep. 9, 2008) (citation and internal quotation marks omitted).
[70] *Id*., at *5.
[71] *Id*., at *4-5.
[72] *Id*., at *6.
[73] *Id*., at *5.
[74] No. 06-35758, 2009 WL 311070 (9th Cir. Feb. 10, 2009).

decisions."[75] The court noted that it "continued to employ the old standards in determining whether . . . a plaintiff's allegations of scienter are as cogent or as compelling as an opposing innocent inference."[76] The only difference now was that the court must "also view the allegations as a whole"[77] – resulting in a two-part inquiry: "[F]irst we will determine whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter; second, if no individual allegations are sufficient, we will conduct a 'holistic' review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or recklessness."[78]

Applying this two-part test, the Ninth Circuit upheld the dismissal of the complaint against DigiMarc. The allegations in *Zucco Partners* involved alleged overstatement of the company's earnings and prospects by "improperly capitalizing (rather than expensing) various internal software development costs."[79] Scienter allegations included: (1) confidential witness statements; (2) restatements of earnings; (3) the resignations of various key accounting executives and the corporations outside auditor during the class period; (4) statements made in DigiMarc's Sarbanes-Oxley certificates; (5) individual defendants' compensation packages; (6) individual defendants' stock sales and (7) a private placement by DigiMarc during the class period.[80] The court first looked at the allegations under its existing rubric and found that individually, none gave rise to a strong inference of scienter.[81] Next, the court performed the *Tellabs* inquiry and analyzed whether the allegations as a whole gave rise to a strong inference of scienter.[82] The holistic inquiry also failed to meet the scienter requirements, and the court noted that sometimes "a set of allegations may create an inference of scienter greater than its

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[75] *Id.*, at *1.
[76] *Id.*
[77] *Id.*
[78] 2009 WL 311070, at *6.
[79] *Id*., at *1.
[80] *Id*., at *6.
[81] *Id*., at *7-20.
[82] *Zucco Partners*, at *21.

parts," that "it was just as likely that combining the group of weak inferences together simply resulted in an equally weak inference overall."[83]

IV. **Developments In Loss Causation**

(1) Pleading Loss Causation

The Ninth Circuit further refined the loss causation pleading standard in two recent opinions, *Metzler Investment GMBH v. Corinthian Colleges, Inc.*,[84] and *In re Gilead Sciences Securities Litigation*.[85]

The corporate defendant in *Metzler* was Corinthian Colleges, Inc., one of the nation's largest operators of private for-profit vocational colleges, with 88 schools in 22 states. Plaintiffs alleged that Corinthian and individual officer defendants engaged in a scheme to misrepresent the number of eligible students enrolled at its campuses to maximize the amount of federal Title IV funding it received. Because Corinthian received 82% of its revenue from federal student loan funding, defendants' alleged fraudulent scheme purportedly caused artificial inflation in Corinthian's share price. The fraud was allegedly revealed through two partial disclosures: (1) on June 24, 2004, the Financial Times reported that the Department of Education ("DOE") was investigating one of Corinthian's campuses for improper financial aid practices; and (2) an August 2, 2004, press release disclosed disappointing earnings and reduced guidance. Plaintiffs alleged that these two press releases, read in tandem, revealed the alleged fraud and caused Corinthian's stock price to plummet.

The Ninth Circuit affirmed dismissal of plaintiffs' complaint for failure to plead loss causation. The Ninth Circuit stated that a plaintiff must plead that the "practices that the plaintiff contends are fraudulent were revealed to the market and

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[83] *Id.*
[84] -- F.3d --, No. 06-55826, 2008 WL 3905427 (9th Cir. Aug. 26, 2008).
[85] 536 F.3d 1049 (9th Cir. 2008).

caused the resulting losses."[86] The court ruled that the DOE investigation revealed potential improper financial aid practices at one of Corinthian's 88 colleges, but did not reveal widespread manipulation of student enrollment.[87] The court also ruled that the August 2 earnings announcement, while conveying disappointing information about Corinthian's current financial condition and its future prospects, did not disclose the alleged fraud.[88] The authors view four key take-aways from *Metzler*.

First, *Metzler* puts to rest, once and for all, the notion that a plaintiff may allege that a fraudulent scheme concealed a company's true financial condition and that any revelation of the "poor financial health generally" reveals the truth to the market.[89] Rather, the market must learn of the specific "practices that the plaintiff contends are fraudulent."[90] The Ninth Circuit discussed its earlier opinion in *In re Daou Systems*[91], and made clear that the only reason that the purported corrective disclosure in *Daou* was sufficient was because "the market learned of and reacted to [the] fraud, as opposed to merely reacting to reports of the defendants' poor financial health generally."[92] The authors have observed that in several instances plaintiffs have attempted to use *Daou* to argue that any revelation of negative economic news reveals a company's true financial condition that was concealed by fraud and satisfies the loss causation pleading standard. *Metzler* provides needed clarity on this point.

Second, the Ninth Circuit held that a corrective disclosure must reveal actual past fraud as opposed to the risk or potential for fraud. It rejected plaintiffs' argument that because the June 24 article revealed issues with financial aid at one of the Corinthian's

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86 2008 WL 3905427, at *10.
87 *Id.*
88 *Id.*
89 *Id.*
90 *Id.*
91 411 F.3d 1006 (9th Cir. 2005).
92 *Id.*

88 campuses, this also revealed the "potential" or "risk" for widespread fraudulent conduct throughout the company.[93]

Third, the Ninth Circuit made clear that plaintiffs could not satisfy their pleading burden with conclusory allegations that the market "understood" that a company's disclosures about its financial metrics connoted past fraudulent conduct. In *Metzler*, plaintiffs alleged that the August 2 earnings release contained a reference to "higher than anticipated attrition" of its students and that the market understood this disclosure as a "euphemism for an admission that they had enrolled students who should not have been signed up at all."[94] The Ninth Circuit observed that "[s]o long as there is a drop in a stock's price, a plaintiff will always be able to contend that the market 'understood' a defendant's statement precipitating a loss as a coded message revealing the fraud."[95] The Ninth Circuit held that a plaintiff must plead a causal connection between a defendant's fraud and the actual loss and could not rely on "loss causation through 'euphemism.'"

Fourth, the Ninth Circuit instructed that while plaintiffs' allegations must be assumed to be true, courts should not "indulge unwarranted inferences."[96] For instance, although plaintiffs alleged that the company's stock price declined in response to the August 2 press release because the market understood the release's reference to higher than expected attrition as a revelation of widespread fraudulent conduct, this allegation was not a "fact" that must be accepted as true. Instead, "the August 2 announcement contained a far more plausible reason for the resulting drop in Corinthian's stock price – the company failed to hit prior earnings estimates."[97]

In *Gilead*, the Ninth Circuit ruled that a corrective disclosure need not immediately be followed by a substantial price decline where plaintiffs have drawn a clear causal connection

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[93] *Id.*
[94] *Id.*, at *11.
[95] *Id.*
[96] *Id.*
[97] *Id.*

between revelation of the fraud and its subsequent impact on stock price.[98] Plaintiffs alleged that the company engaged in an off-label marketing scheme for its main product, Viread. Viread was an antiretroviral agent used in combination with other drugs to treat HIV. Plaintiffs alleged that the market learned of the scheme on August 7, 2003, when the Food and Drug Administration made public a "Warning Letter" it issued to the company regarding its improper promotional activities. Plaintiffs further alleged that although the market did not immediately appreciate or react to the August 7, 2003, disclosure, physicians reacted to it by sharply reducing their demand for Viread. There was no market response until October 28, 2003, when the company's stock price sharply declined on news of the company's third quarter financial results, which reflected sharply reduced demand for Viread. The district court held that plaintiffs had not pled loss causation because Gilead's stock price did not decline in response to disclosure of the Warning Letter, and the October 2003 press release did not reveal the fraud, only a sharply decreased decline for Viread. The Ninth Circuit reversed, holding that plaintiffs sufficiently alleged a causal connection between the alleged fraud and Gilead's price decline.[99] Specifically, while the market did not necessarily appreciate the immediate import of the Warning Letter, plaintiffs alleged that the Warning Letter revealed the fraud to physicians and directly resulted in a reduction in demand. Plaintiffs further allege that when the company issued its disappointing third quarter financial results, analysts concluded that Gilead's poor results were caused by poor end-user demand for Viread. This poor end-user demand was allegedly the direct result of the public disclosure of the Warning Letter. The Ninth Circuit held that while plaintiffs had not alleged that the market immediately recognized the significance of the August 2003 Warning Letter disclosure and the company's stock price did not immediately decline, plaintiffs had carefully drawn a causal connection between revelation of the fraud to physicians, the resulting reduction in demand for Viread and its subsequent impact on Gilead's stock price.[100]

[98] 536 F.3d at 1057-58.
[99] *Id*. at 1057.
[100] *Id.* at 1057-58.

Gilead may not have wide application beyond its narrow facts. The key take-away is while plaintiffs must plead a clear causal connection between the corrective disclosure and the subsequent decline in the company's stock price, the price decline need not be immediate where plaintiffs have plausibly established a chain of events that led from the disclosure to the decline.

(2) Loss Causation at the Summary Judgment Stage

In *In re Retek Inc. Securities Litigation*, the district court for the District of Minnesota granted the defendants' motion for summary judgment on loss causation grounds. This case is noteworthy because the court engages in a detailed discussion of what kind of showing of loss causation must be made to survive summary judgment.

Plaintiffs stated that a July 8, 2002, press release that stated Retek "saw sales cycles extend as a result of working with larger customers that have more complex and lengthy procurement processes" and as a result anticipated revenue was deferred with respect to one customer was a corrective disclosure. The plaintiffs claimed that this press release also indirectly disclosed misrepresentations relating to four other transactions at issue. While the court, relying on *In re Daou Systems, Inc. Securities Litigation*, noted that fraud could be revealed through indirect disclosure, it held that a plaintiff must still prove that the "market recognized a relationship between the event disclosed and the fraud in order to establish loss causation."

The court discussed the burden on summary judgment versus on motion to dismiss, and stated that in contrast to a motion to dismiss, at the summary judgment stage, parties have "developed the record through discovery and there is an expectation that the parties have had the opportunity to produce evidence supporting their claims and defenses." And in contrast to *Dura Pharmaceuticals, Inc. v. Broudo*, at the summary judgment stage "plaintiffs are past the point of placing Retek on notice of what plaintiffs intend to prove," and instead "the Court reviews the record to determine whether plaintiffs have adduced evidence such that a rational trier of fact could find in their favor on the issue of loss causation." The court summed up its discussion with emphasizing that "plaintiffs must produce evidence that the market became aware of Retek's alleged misrepresentation as a result of the July 8 press release," and that there was a consequential drop in stock price.

The court concluded that the plaintiffs failed to put forth any evidence that the July 8 press release either was a corrective disclosure for the customer directly mentioned in it (because the press release only repackaged information that was already publicly available) or indirectly for the other four transactions at issue because, the court found and even the plaintiffs' expert conceded, that "until the original complaint was filed, there was no disclosure such that the market became aware that Retek had committed improper or fraudulent practices regarding those four ventures." As a result, the court granted defendant's motion for summary judgment in full.

(3) Loss Causation and Class Certification

In *Alaska Electrical Pension Fund v. Flowserve Corporation*,[101] retired U.S. Supreme Court Justice Sandra Day O'Connor, sitting by designation, reversed denial of class certification on loss causation grounds. The Fifth Circuit affirmed that on class certification plaintiff bore the burden of showing loss causation by a preponderance of the evidence, but concluded that the lower court "applied an incorrect standard of loss causation."

The circuit court observed that the reason that the district concluded that plaintiffs' had not proven loss causation was because plaintiffs had not identified a "fact-for-fact" disclosure of information that "specifically reveals the fraud."[102] For example, the district court concluded that reductions of the company's FY2002 earnings guidance in July and September 2002, did not reveal that the company's original FY2002 earnings projections, made in October 2001, were fraudulent. The circuit court held that this ruling applied an incorrect standard of loss causation because

[101] Nos. 07-11303, 08-10071, 2009 WL 1740648 (5th Cir. June 19, 2009).
[102] *Id.* at *9.

for a disclosure to be corrective it need not precisely mirror prior misstatements but must instead reveal the relevant truth obscured by the purported fraud. Thus, it would have been sufficient to show that the market learned that the company's October 2001 guidance was wrong, that the stock price significantly declined in response to that disclosure and that other negative information unrelated to the alleged fraud did not cause the stock price movement.[103] The circuit court noted that plaintiffs offered expert testimony that unrelated negative information did not cause the decline in the company's stock price. At the same time, the circuit court cautioned that the reduction in earnings guidance alone would not be sufficient to establish loss causation because such a disclosure only shows that the "business seemed less valuable."[104] Rather, plaintiffs were required to show by a preponderance of the evidence that past misstatements caused the stock price to significantly decline. The circuit court also questioned the district court's conclusion that twenty-one of the alleged misstatements were "confirmatory" and therefore nonactionable because they did not reveal new information to the market. It noted that the company's stock price increased in reaction to these statements, indicating that they introduced new information to the market. The circuit court therefore remanded the case to the district court for a new hearing on loss causation with instructions to apply the correct legal standard and framework.

In addition to providing additional guidance on the Fifth Circuit's perspective of the proper standard of loss causation in the class certification stage, *Flowserve* reaffirms the continuing vitality of *Oscar Private Equity Investments v. Allegiance Telecom, Inc*.[105] The *Flowserve* court cited *Oscar* with approval for the proposition that a securities plaintiff must establish loss causation by a preponderance of admissible evidence at the class certification stage.[106]

[103] *Id.* at *8.
[104] *Id.* at *9.
[105] 487 F.3d 261, 262 (5th Cir. 2007).
[106] 2009 WL 1740648, at *5.

While *Oscar* still has not gained wide acceptance outside of the Fifth Circuit,[107] the *Oscar* decision continues to represent a breakthrough for securities fraud defendants as courts traditionally have certified securities class actions without much analysis of Rule 23's requirements. The Fifth Circuit's recognition of the costs associated with this practice, as well as the fact that "class certification . . . [bears] due-process concerns [for] both plaintiffs and defendants," is significant.[108] The impact of *Oscar* beyond the Fifth Circuit remains to be seen. This evolving Fifth Circuit doctrine will force a discourse over the appropriate limits on the fraud-on-the-market presumption and perhaps provide securities defendants with greater due process rights during class certification.

V. **Developments in Collective Scienter Doctrine – *Glazer Capital Management, LP v. Sergio Magistri***

The Ninth Circuit recently defined the proper application of the collective scienter doctrine. In *Glazer Capital Management, LP v. Sergio Magistri*,[109] plaintiffs brought an action against Invision Tech. Inc. ("Invision") and its officers for alleged violation of Section 10(b) of the Securities Exchange Act. The complaint alleged that in March 2004, Invision announced that it had entered into a merger agreement with GE and on the same day filed its 10K with the merger agreement as an attachment to its filing. The complaint further alleged that the merger agreement contained false or misleading statements. In July 2004, Invision

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[107] *See, e.g., In re Boston Sci. Corp. Secs. Litig.*, 604 F. Supp. 2d 275, 285 (D. Mass. 2009); Ross v. Abercrombie & Fitch *Co*., 2008 WL 4059873, at *2 (S.D. Ohio Aug. 26, 2008) ("Loss causation is not a factor listed in Rule 23. In a securities case, any issue relating to causation is an element of the plaintiffs cause of action . . . Ordinarily, the Court should not consider the merits of the case when deciding if a class should be certified."); *but see In re Credit Suisse First Boston Corp. (Lantronix, Inc.) Analyst Sec. Litig*., 250 F.R.D. 137 (S.D.N.Y. 2008) (granting defendants' motion to decertify a class because of plaintiffs' failure to establish loss causation at class certification).

[108] 487 F.3d at 267.

[109] 549 F. 3d 736, 749 (2008).

allegedly issued a press release revealing that it was under investigation for potential violations of the Foreign Corrupt Practices Act . This allegedly caused an immediate drop in the company's share price.[110] After several rounds of amendment, the District Court dismissed the action without leave to amend and an appeal followed.

The most significant aspect of the Ninth Circuit's *Glazer* opinion was its ruling on the doctrine of "collective scienter." This doctrine suggests that under certain circumstances a company may be deemed to have fraudulent intent even though plaintiffs are unable to show that any individual officer or director had such intent. In *Glazer*, plaintiffs argued that the Ninth Circuit should invoke that doctrine to permit their case to proceed against Invision despite their failure to plead scienter as to any individual. The Ninth Circuit noted that in *Tellabs II*, the Seventh Circuit held that "there could be circumstances in which a company's public statements were so important and so dramatically false that they would create a strong inference that at least *some* corporate officials knew of the falsity upon publication."[111] The Ninth Circuit chose not to reach the question of whether, under certain circumstances, the doctrine of collective scienter was viable. But it concluded that the alleged misrepresentations in *Glazer* did not give rise to the extreme circumstances under which *Tellabs II* recognized the collective scienter doctrine.

VI. **Developments in the Advancement and Indemnification of Legal Fees for Former Officers - *In re HealthSouth Corp. Securities Litigation***

The Eleventh Circuit recently held in *In re HealthSouth Corp. Securities Litigation* that companies settling securities class actions can include Reform Act bar orders that extinguish their former officers' statutory and contractual rights to advancement

[110] *Id*. at 739.
[111] *Id.* at 744.

and indemnification of legal fees. Despite Delaware's presumption in favor of defense-cost indemnification and advancement, the circuit court affirmed HealthSouth's use of a Reform Act bar order to extinguish its obligation to advance defense costs to its non-settling former CEO.

HealthSouth and the class action plaintiffs had reached a settlement in which HealthSouth and its insurers agreed to pay $445 million. Richard Scrushy, HealthSouth's former chairman and CEO, was named as a defendant but not included in the settlement. The settlement agreement called for a bar order that extinguished not only Scrushy's right to seek contribution from HealthSouth for any liability he had to plaintiffs, but also foreclosed any further indemnification obligations HealthSouth had for defense costs. The district court approved the settlement and bar order over Scrushy's objections, and he appealed to the Eleventh Circuit. He argued, among other things, that the bar order impermissibly extinguished his contractual claims against HealthSouth for advancement of defense costs. Scrushy presented three arguments in support of his objection, and the court rejected all of them.

First, Scrushy argued that the order was not appropriate under the Reform Act or case law interpreting it, because his advancement claim against HealthSouth was independent of the plaintiffs' securities fraud claim and therefore could not be settled between plaintiffs and HealthSouth. The court found a sufficient relationship between Scrushy's advancement claim and the underlying securities claim because Scrushy would have no need to claim defense costs if he were not being sued by plaintiffs. As the court put it, "the attorneys' fees for which Scrushy seeks advancement were incurred on account of Scrushy's liability or the risk thereof to the underlying plaintiffs."

Second, Scrushy argued that public policy supported the advancement of attorneys' fees. The court noted that Delaware law is pro-advancement. The reason often given is that Delaware corporations want the best individuals to serve on their boards and as their officers and to encourage them to do so corporations need to guarantee that these individuals will be protected from meritless litigation. The court held that this policy was outweighed by a policy favoring settlements, and HealthSouth would have been unlikely to settle if it continued to be liable to Scrushy for his defense costs. The court suggested that these considerations might balance differently for an executive who had made a showing that he was a mere innocent bystander caught in a securities, but Scrushy had not made any showing to the district court to rebut plaintiffs' allegations that he was a central figure in the alleged fraud.

Third, Scrushy argued that the bar order cutting off his advancement could not be justified like a typical bar order because he did not receive the consideration of reciprocity—he owed HealthSouth no contractual obligation to advance its defense costs. The court held that precise reciprocity was not necessary; the bar order's protection for Scrushy from any claims by HealthSouth was sufficient compensation to him for losing his advancement rights. Again the court suggested that the calculus might differ for an innocent executive: "This constitutes very significant compensation to Scrushy, in light of the perception by the underlying plaintiffs and HealthSouth that Scrushy was a central figure in the violations."

This decision is noteworthy because the Eleventh Circuit's willingness to permit issuers to extend Reform Act bar orders to block defense-cost advancement claims should tip the scales of bargaining power and encourage a change in behavior from each of the parties. For their part, issuers may make such broad bar orders standard operating procedure in their settlement agreements if they intend to cut a former executive loose in the settlement. And since an unrepresented executive would be more vulnerable to plaintiffs, they would happy to agree to the broad bar order. The non-settling defendant may or may not succeed in his objection to the bar order, but there is little harm in the parties including it.

The ability to "buy peace" with a bar order might also make companies more willing to settle without their former executives, rather than attempt to reach a global settlement. To protect themselves, directors or officers might obtain a Delaware judgment immediately that they are entitled to advancement until the case is resolved against them. Delaware provides for expedited proceedings in advancement cases, and at the first sign of trouble—*e.g.*, the company is late paying the executive's submitted legal bill—the executive would have an excuse to file a summary proceeding in Delaware seeking such an order. Presumably, the court in which the securities action is pending would want to avoid a direct conflict with the court of the state of the company's incorporation.

VII. **Section 10(b) Statute of Limitations – When is a plaintiff put on inquiry notice of securities fraud? – *In re Merck & Co. Securities, Derivative & "ERISA" Litigation***

The United States Supreme Court recently granted *certiorari* in *In re Merck & Co. Securities, Derivative & "ERISA" Litigation* to resolve a widening a rift between the circuits regarding when an investor is put on inquiry notice of fraud for the purposes of starting the statute of limitations clock for Section 10(b) actions.

Merck involves the alleged misrepresentation of the safety and commercial viability of the drug Vioxx – a pain reliever that was withdrawn from the market in September 2004 due to safety concerns – which, in turn, allegedly caused Merck's stock price to fall dramatically. The central question in *Merck* is whether there was enough publicly-available information to trigger an investor's duty to investigate the alleged fraud and to begin the running of the statute of limitations more than two years prior to the filing of the action. If so, defendants argued that plaintiffs' claims were time-barred. There were many potential "storm warnings" of fraud more than two years before the November 2003 filing of the securities lawsuit, including clinical trial results in a 2000 press release, an August 2001 article in the Journal of the American Medical Association, a September 2001 public posting on the FDA website and an October 2001 New York Times article. Despite this public information, the plaintiffs did not conduct an investigation into the potential fraud, and waited to file their lawsuit for more than two years after the "storm warnings."

In analyzing whether the action was time-barred, the Third Circuit reaffirmed its holding in *Benak ex. rel. Alliance Premier Growth Fund v. Alliance Capital Management L.P.*: "whether the plaintiffs, in the exercise of reasonable diligence, should have known of the basis for their claims depends on whether they had sufficient information of possible wrongdoing to place them on inquiry notice or to excite storm warnings of culpable activity." Then, looking at the different categories of disclosed information, the court found that "the District Court acted prematurely in finding that [plaintiffs] were on inquiry notice of the alleged fraud." Following the logic of the Ninth Circuit in *Betz v. Trainer Wortham & Company*, the court determined that because the storm warnings provided "no reason to suspect that Merck did not believe" its earlier studies on the safety profile and commercial viability of Vioxx, those warnings did not put plaintiffs on inquiry notice. As such, the Third Circuit found that the lawsuit was not time-barred because there was no evidence of scienter in the storm warnings, and therefore the investors were not on inquiry notice and had no duty to conduct an investigation.

Merck petitioned for *certiorari* seeking to reconcile the reasoning of the Third and Ninth Circuits with other circuit courts that had considered what is sufficient to put an investor on "inquiry notice" for the purposes of starting the statute of limitations clock. Merck noted that the Eleventh and Fourth Circuits and sometimes the Fifth and Eighth circuits started the clock when warnings issued of possible fraud that would prompt a reasonable investor to investigate whether it had been defrauded. Further, the First, Sixth, Seventh and Tenth Circuits, and sometimes the Second Circuit consider the statute of limitations to be triggered when an investor is actually or constructively aware of the possibility that it has been defrauded, and exercising reasonable diligence could have discovered facts underlying the alleged fraud. Merck argued that "the Third Circuit has excused an investor from asking a single question until it has evidence not just of scienter, but of materiality and loss causation as well" and that this reasoning "runs contrary to the fundamental purpose of inquiry notice – to encourage the timely filing of fraud claims by placing an affirmative burden on plaintiffs to investigate potential claims." The coming year may provide important guidance from the Supreme Court on when a plaintiff develops a duty to investigate wrongdoing and when the statute of limitations for securities fraud begins to run.

VIII. Subprime Mortgage Securities Class Actions

Over the past year, the reverberations from the subprime meltdown have continued in full force. The subprime meltdown has now evolved into a full-scale, worldwide credit crisis – complete with the failure of 25 U.S. banks in 2008 and of 37 U.S. banks so far in 2009 [112] -- with no end yet in sight. The U.S. Government has spent trillions of dollars in the past year attempting to "bail out" companies and "rescue" the economy.[113]

Issues with subprime loans are credited with being harbingers of the crisis. A subprime loan is a loan made to borrowers with substandard credit or unstable income, who would otherwise be shut out of the housing market.[114] Gaining popularity in the late 1990s, most of the loans issued were no money down, required little or no income documentation and started with low adjustable rates, thereby enabling people to purchase homes that they otherwise could not afford.[115] These loans were known in some quarters as "ninja loans" – no income, no job or assets.[116] The subprime mortgage meltdown emerged when the interest rates on these loans, often beginning as "teaser" adjustable rates, started

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[112] "Failed Bank List," *Federal Deposit Insurance Corporation*, last updated June 12, 2009, available at http://www.fdic.gov/bank/individual/failed/banklist.html (last visited on June 14, 2009).
[113] CNNmoney.com's Bailout Tracker, last updated on June 9, 2009, available at http://money.cnn.com/news/storysupplement/economy/bailouttracker/index.html (last visited on June 14, 2009).
[114] Kenneth C. Johnston, et al., *The Subprime Morass: Past, Present, and Future*, 12 N.C. Banking Inst. 125, 125-26 (2008).
[115] *Id.* at 126.
[116] *Risky-Mortgage Meltdown was Predictable, Preventable,* USA Today, Opinion, Aug. 10, 2007, *available at* http://blogs.usatoday.com/oped/2007/08/post-8.html (last visited June 16, 2008).

to adjust and re-set at substantially higher rates that borrowers could not afford.[117] These risky debts were packaged with other debts in what is called a "structured investment vehicle" that were widely traded on Wall Street. When hedge funds began trading these subprime-laden SIVs, the funds had taken on confidence-inspiring monikers like "High-Grade Structured Credit Enhanced Leverage Fund."[118] As interest rates rose, many defaulting borrowers, with little or no equity in their homes, simply walked away from their homes, unable or unwilling to make large monthly payments on properties that were now worth significantly less than the amount borrowed against them. Lenders and the institutions they borrowed funds from began to lose money exponentially as droves of borrowers defaulted.[119] Losses from the subprime meltdown have been estimated in the trillions of dollars, and keep climbing.

This phenomenon spurred a flurry of litigation. Within the securities class action arena, of the 210 cases filed in 2008, 76 were related to the subprime meltdown/liquidity crisis.[120] The cases continue follow a general theme: the defendants issued loans to risky borrowers who defaulted, and the defendants misrepresented the company's health amidst the subprime meltdown to the detriment of investors.

Settlements have started to appear, with the Merrill Lynch settlement at the head of the pack. In January 2009, Merrill Lynch agreed to pay $475 million to settle a subprime mortgage-based securities class action that alleged that it made false and misleading statements concerning its exposure to subprime debt.[121]

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[117] Johnston, et al., *supra* note 114, at 126.
[118] John Stepek, *US Subprime Woes Start to Spread*, Money Week, June 25, 2007, *available at* http://www.moneyweek.com/file/31223/us-subprime-woes-start-to-spread.html (last visited June 4, 2008)
[119] Johnston, et al., *supra* note 114, at 131-32.
[120] Cornerstone Research, *Securities Class Action Filings – 2008: A Year in Review*, at p. 4.
[121] Melissa Maleske, *Merrill Lynch Settles Subprime Class Action*, InsideCounsel (Jan. 19, 2009), available at http://www.insidecounsel.com/News/2009/1/Pages/Merrill-Lynch-Settles-Subprime-Class-Action.aspx (last visited June 14, 2009).

In May 2009, Beazer Homes announced the settlement of a subprime-related securities class action in the amount of $30.5 million.[122] The Beazer Homes settlement is awaiting court approval.[123] The remaining two of four subprime securities class actions to have settled thus far are: Luminent Mortgage Capital ($8 million) and WSB Financial Group ($4.65 million).[124]

Most of these lawsuits are still winding their way through the district courts, with a few having progressed to the motion to dismiss stage.

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[122] Kevin LaCroix, *Beazer Homes Settles Subprime Securities Lawsuit*, D&O Diary (May 5, 2009), available at http://www.dandodiary.com/2009/05/articles/subprime-litigation/beazer-homes-settles-subprime-securities-lawsuit/ (last visited June 14, 2009).
[123] *Id.*
[124] Kevin LaCroix, *Subprime and Credit Crisis-Related Lawsuits Settlements, Dismissals and Denials*, available at http://www.dandodiary.com/2008/06/articles/subprime-litigation/the-list-subprime-lawsuit-dismissals-and-denials/index.html (last visited June 14, 2009).

Recent Cases of Note:

(1) Second Circuit

In *In re Moody's Corp. Securities Litigation*, plaintiffs brought securities fraud claims against Moody's Corporation, one of the nation's largest credit rating agencies, for alleged violations of Section 10(b) and Rule 10b-5.[125] Plaintiffs alleged that defendants made a number of false or misleading statements in connection with Moody's ratings of structured finance products, such as residential mortgage-backed securities, collateralized debt obligations, and structured investment vehicles. Specifically, plaintiffs alleged that defendants made misrepresentations regarding: 1) Moody's independence, the integrity of its ratings and its handling of conflicts of interest; 2) the meaning of Moody's ratings; 3) Moody's structured finance revenue; and 4) Moody's rating methodologies.[126] The court granted in part and denied in part defendants' motion to dismiss the complaint.

First, the court rejected defendants' argument that plaintiffs' claims were time-barred because they were put on inquiry notice in July 2003 by public statements concerning potential conflicts of interest in the credit-ratings industry.[127] The court noted that the newspaper articles and media reports cited by defendants discussed potential conflicts in the ratings industry in general terms but most not specifically mention Moody's.[128] Even the ones that did only raised concerns about mismanagement of conflicts rather than fraud. Moreover, the court ruled that investors were entitled to rely on numerous "words of comfort" by Moody's management that the media criticisms did not apply to Moody's.[129]

Second, the court concluded that plaintiffs adequately alleged that defendants made false or misleading statements regarding Moody's independence and regarding its ratings

[125] 599 F. Supp. 2d 493 (S.D.N.Y. 2009).
[126] *Id.* at 501-02.
[127] *Id*. at 506-07.
[128] *Id.* at 506.
[129] *Id.*

methodologies. The court noted that the complaint contained numerous specific allegations that showed that, *inter alia*, Moody's modified its ratings to respond to client complaints, that it fired mortgage-backed securities analysts that gave ratings that were too conservative, that Moody's employees and clients attempted to raise questions about Moody's independence, and that Moody's internal ratings methodologies were inconsistent with its public disclosures.[130] The court held, however, that defendants' alleged statements regarding the meaning of structured finance securities and its statements that Moody's structured finance revenues were from legitimate sources did not constitute actionable misrepresentations because plaintiffs had not alleged sufficient facts showing that these statements were false.

Third, the court found that the complaint alleged strong circumstantial evidence of scienter by Moody's CEO. Specifically, the complaint alleged the contents of a confidential slideshow in which the CEO made a number of statements suggesting that he had contemporaneous knowledge that Moody's public statements were false and misleading.[131] Based on the CEO's alleged fraudulent intent, the court concluded that the complaint also alleged scienter as to Moody's. The court concluded that the complaint failed to allege specific facts showing contemporaneous fraudulent intent by two other defendant executives and dismissed them on that basis.

Fourth, the court held that plaintiffs had successfully pled loss causation because the complaint identified specific disclosures related to Moody's independence and ratings methodologies that were followed by significant price declines.[132] A particularly noteworthy aspect of this opinion is the court's analysis of whether the "market crash as a result of the subprime mortgage crisis" was an intervening factor that broke the causal chain between defendants' alleged fraud and the subsequent price declines.[133] The court stated that "[w]here there is a market-wide downturn in a

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[130] *Id.* at 509-10.
[131] *Id.* at 515.
[132] *Id.* at 512-13.
[133] *Id.* at 513.

particular industry [] Plaintiffs must show that their loss was caused by Defendants' fraud, rather than intervening events, in order to survive a motion to dismiss."[134] The court then studied the stock price movements of Moody's competitors and concluded that it could not find, based on the pleadings, that there was an industry-wide down turn in the credit rating agency industry because other credit rating agencies did not suffer price declines at the same time as the declines in Moody's stock.[135] The court's approach may be very beneficial to defendants in future cases because it requires plaintiffs to allege specifically why intervening factors do not defeat their loss causation allegations where competitor price movements evidence an industry-wide downturn.

(2) Third Circuit

In re Radian Securities Litigation, involves a credit enhancement company that provides mortgage insurance and other financial services and products to mortgage lenders and other financial institutions.[136] Radian held a 46 percent equity interest in C-BASS, a corporation investing in the credit risk of subprime residential mortgages. Plaintiffs alleged that starting in January 2007, the changing market conditions made the mortgage-backed securities securitized by C-BASS particularly risky investments and that Radian and several individual defendants violated Section 10(b) by making false and misleading statements about the profitability and liquidity position of C-BASS. Plaintiffs also alleged that defendants failed to timely take an impairment of Radian's investment in C-Bass.[137]

The court granted a motion to dismiss plaintiffs' claims because it concluded that the complaint did not adequately allege scienter.[138] The court rejected plaintiffs' argument that defendants had a motive to commit fraud because they wanted to close a merger between Radian and another company because such

[134] *Id.*
[135] *Id.*
[136] No. 07-3375 MASTER FILE, 2009 U.S. Dist. LEXIS 30224, at *2 (E.D. Pa. Apr. 9, 2009).
[137] *Id*., at *30.
[138] *Id*., at *81.

motives are common to all officers and directors and are therefore not suggestive of fraud.[139] The court concluded that plaintiffs' insider trading allegations were insufficient to show scienter because the complaint did not allege the defendants' trading history or show that their stock sales were unusual in scope.[140] The court likewise rejected the complaint's allegations that defendants' failure to take an earlier impairment in C-BASS was reckless in light of the deterioration of the subprime market. The court concluded that the complaint did not allege with particularity that C-BASS was actually impaired at an earlier time.[141] Moreover, the complaint did not allege sufficient facts that the accounting decision not to take an earlier impairment was "an extreme departure from the range of reasonable business treatments permitted under GAAP" to constitute recklessness.[142] Furthermore, the complaint lacked particularized allegations that any of the defendants knowingly made false statements to the public. Finally, the court rejected the complaint's assertion that the resignation of Radian's auditor, absent any allegation specifically linking the resignation to the alleged fraud, supported a finding of scienter.[143]

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[139] *Id.*, at *38-39.
[140] *Id*., at *41-51.
[141] *Id*., at *54-57.
[142] *Id*., at *56-57.
[143] *Id*., at *78.

(3) Ninth Circuit

Pittleman v. Impac Mortgage Holdings, Inc., involved a shareholder suit against Impac Mortgage Holdings, Inc., a mortgage lender that specialized in "Alt-A" loans.[144] The court dismissed the action for failure to plead scienter, and denied leave to amend because it concluded that further amendment would be futile. The court noted that the allegations of the complaint, which relied heavily on five confidential witnesses, were "so vague to be meaningless" and "too generic to satisfy the scienter requirement."[145] For instance, one confidential witness purportedly stated that defendants' actions were "in violation of standard due diligence procedures" but fails to identify any specific violative acts or diligence procedures.[146] The witness further purportedly states that when "bulk pool loans" did not satisfy Impac's "guidelines" they were still approved by Impac's management. But it again fails to identify specific bulk loan pools or why they did not satisfy Impac's guidelines. Another confidential witness purportedly made vague statements that he recalled "significant pressure" to approve one loan pool and that there were certain companies that were "notorious" for selling bulk loan pools to Impac.[147] Again, the court held that such allegations did not give rise to a strong inference of fraudulent intent on the part of any defendant. The court also rejected plaintiffs' reliance on the *South Ferry* case and the "core operations inference." The court said that the facts alleged did not show the "exceedingly rare" circumstance where an event was so "prominent that it would be 'absurd' to suggest that key officers lacked knowledge of it.[148] Because plaintiffs failed to allege scienter by the individual defendants making the alleged false and misleading statements, the court held that plaintiffs had also failed to show scienter by Impac, citing *Glazer*.[149]

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[144] SACV 07-0970 AG (ML Gx), 2009 U.S. Dist. LEXIS 18213, at *1 (C. D. Cal. Mar. 9, 2009).
[145] *Id*., at *6.
[146] *Id*., at *7.
[147] *Id*., at *8.
[148] *Id*., at *9.
[149] *Id*., at *10.

In *In re Washington Mutual, Inc. Securities*, *Derivative & Erisa Litigation*, plaintiffs asserted claims under Section 10(b) and 20(a) of the Securities Exchange Act, and under Section 11, 12(a)(2), and 15 of the Securities Act.[150] Plaintiffs alleged four types of improper activities regarding WaMu's home lending business: (1) "deliberate and secret efforts" to decrease the efficacy of WaMu's risk management policies; (2) corruption of WaMu's appraisal process; (3) abandonment of appropriate underwriting standards for WaMu loans; and (4) misrepresentation of financial results.[151] The court rejected plaintiff's Exchange Act claims because the voluminous complaint was so poorly organized and drafted that the court concluded that it did not give defendants fair notice of plaintiffs' claims. The court ordered plaintiffs to provide a more definite statement in an amended complaint.[152]

As for the Section 11 claim, the court concluded that plaintiffs' allegations regarding WaMu's alleged underwriting standards and internal controls satisfied the notice pleading requirements of Rule 8(a) of the Federal Rules of Civil Procedure.[153] Specifically, the complaint alleged that statements in the WaMu's registration statement that it was ensuring compliance with its underwriting standards were false or misleading because the complaint contained specific allegations showing that WaMu was lowering its underwriting standards.[154] The court found that the complaint's statements regarding the strength of WaMu's internal controls were likewise false or misleading based on allegations from a confidential witness regarding the erosion of those internal controls particularly with respect to WaMu's key model to predict losses.[155] In particular, the court noted that WaMu's representation that it continually updated its internal controls to maintain their effectiveness "[wa]s specifically contradicted" by allegations that the company "intentionally decreased the regulatory power of the risk management group" and

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[150] No. C08-387 MJP, 2009 U.S. Dist. LEXIS 41575, at *5 (W.D. Wash. May 15, 2009).
[151] *Id*., at *10-11.
[152] *Id*., at *36-37.
[153] *Id*., at *44.
[154] *Id*., at *47.
[155] *Id*., at *49.

"failed to update its system for predicting credit risk."[156] The court concluded that the complaint's allegations regarding false and misleading information in the financial statements contained in the offering document sounded in fraud and were subject to the heightened pleading standards of Rule 9(b). The court found that the complaint satisfied Rule 9(b) because it contained particularized pleadings regarding how under-provisioned its loan loss allowance and overstated its net income, and identified the individuals responsible for the conduct that caused the misstatements. Based on the above analysis, the district court ruled that the Section 12(a)(2) claim against the Underwriter defendants could go forward as well.[157]

In *In Re Downey Securities Litigation*, plaintiffs alleged that Downey Financial Corporation and individual defendants misrepresented the quality of Downey's loan portfolio and its underwriting practices. The court granted the defendants' motions to dismiss with leave to amend, finding that the plaintiffs failed to plead falsity, scienter, and loss causation.[158]

First, the court noted that the complaint failed to allege that any of the individual defendants made an actionable misrepresentation. The statements attributed to the individual defendants were too vague and amorphous to be actionable or the complaint failed to show that they were actually false. For instance, the complaint alleged that any borrower with a FICO score of less than 660 should be considered subprime and therefore an individual defendant's statement that only 6% of Downey's loan portfolio was subprime was false because a larger percentage of the borrowers in the portfolio had lower FICO scores.[159] The court noted, however, that Downey disclosed that it considered FICO scores of 620 or below to be subprime and that Downey's definition was widely used in the mortgage industry. Under that measure, the defendant's estimate of Downey's subprime portfolio

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[156] *Id*., at *50.
[157] *Id*., at *56.
[158] CV 08-3261-JFW (RZx), 2009 U.S. Dist. LEXIS 25007, at *4 (C.D.Cal. Mar. 18, 2009).
[159] *Id*., at *18.

was true. The court rejected the argument that the individual defendants should be held responsible for the alleged false statements in Downey's SEC filings because the complaint was devoid of allegations that the individuals played any role in preparation of the false statement.[160]

Second, the court concluded that the complaint failed to plead facts that gave rise to a strong inference of scienter. The court held that the individual defendants' corporate positions or that they signed Downey's public filings or that the company's financial statements did not comply with GAAP did not support an inference of scienter.[161] Allegations that some executives resigned was likewise not indicative of scienter absent specific allegations that the resignations were connected to fraudulent activity.[162] The court further held that the allegations of thirteen confidential witnesses did not help plaintiff's scienter showing because these allegations lacked the requisite specificity. The allegations failed to allege with specificity the witnesses' job titles, roles, or the basis for their allegations. In many instances, the allegations were "not only vague and conclusory, but based on rumor or hearsay."[163] Finally, the court noted that the individual defendants failed to sell substantial stock during the class period and suffered significant losses as a result of their decision to remain invested in Downey. It found that this "negated" any inference of scienter that may have been raised by other allegations in the complaint.[164]

Third, the court held that the complaint failed to plead loss causation. The complaint alleged that Downey's earnings releases and financial reports during the class period and a January 14, 2008 press release regarding the restatement of $99 million in loans as troubled debt restructurings caused Downey's stock price to fall between October 16, 2006, and July 28, 2008. But the Court held that the public disclosures reference did not disclose any wrongdoing by Downey and, "at best, demonstrate only that

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[160] *Id*., at *21.
[161] *Id*., at *26-36.
[162] *Id*., at *30-32.
[163] *Id*., at *38.
[164] *Id*., at *41.

the market learned of and reacted to Downey's poor financial held rather than any alleged fraud.[165]

In *In re PMI Group, Inc. Securities Litigation*, plaintiffs brought an action against one of the nation's largest private mortgage insurance companies and several of its officers and directors for alleged violations of Section 10(b) of the Exchange Act.[166] The complaint alleged that defendants made false and misleading statements regarding: (1) the nature and scope of PMI's underwriting practices; (2) PMI's exposure to high risk loans; (3) the value of its equity investment in Financial Guaranty Insurance Company, Inc. ("FGIC"), a financial guaranty insurance company with exposure to risky credit default swap instruments; and (4) its loss reserves.

In ruling on defendants' motion to dismiss, U.S. District Judge Susan Ilston concluded that the complaint adequately pled falsity for these categories of allegations. The court held that the complaint adequately alleged that PMI's loss reserves and PMI's accounting for its FGIC investment were incorrect. It further held that although defendants made a number of statements to the market regarding PMI's underwriting practices and its exposure to high risk loans, they also made other statements about PMI's prudent risk management. On balance, the court concluded that these statements were sufficiently pled as false and misleading.[167] The court also concluded that the complaint adequately pled loss causation because it alleged several partial corrective disclosures followed by significant price declines.[168]

The court dismissed plaintiffs' complaint, however, because it found that the allegations did not give rise to a strong inference of scienter. It held that the purported statements of the three confidential witnesses in the complaint did not show that any of the individual defendants had personal knowledge that the alleged misstatements were false or misleading. For instance, one

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[165] *Id*., at *44.
[166] No. 3:08-cv-01405-SI (N.D. Cal. July 1, 2009).
[167] *Id.* at 11.
[168] *Id.* at 16.

confidential witness allegedly prepared internal reports that showed that the portfolios of certain lenders were not performing according to PMI's risk standards but the complaint lacked sufficient detail regarding the contents of these reports and was devoid of any allegation that the witness had personal knowledge that any of the defendants received these reports.[169] The court also rejected allegations that the individual defendants engaged in suspicious insider sales. The court noted that the complaint did not allege the individual defendants' prior trading history and therefore necessarily failed to show that trades during the class period were suspicious. The court further noted that the individual defendants actually increased their holdings during the class period, behavior that "is inconsistent with an intent to defraud."[170] Furthermore, many of the trades were pursuant 10b5-1 trading plans and such trades "may rebut an inference of scienter." Finally, the court held that allegations that PMI had a bonus compensation plan tied to the company's performance did not support an inference of scienter.

The court squarely rejected plaintiffs' attempt to circumvent the shortcomings of the complaint's scienter pleading by invoking the "core operations" inference. The court held that the complaint did not present the "exceedingly rare" category of cases where, under *South Ferry*, the core operations inference alone could establish scienter.[171] Given the complaint's failure to show that the individual defendants had actual information of the falsity of the alleged misstatements, the court concluded that it failed to show a strong inference of scienter.

In *In re Countrywide Financial Corporation Securities Litigation*, plaintiffs brought an action against Countrywide Financial Corp, its officers and directors, underwriters of its securities offerings, and its auditor for alleged violation of Sections 11 and 12(a)(2) under the Securities Act and Section 10(b) under the Securities Exchange Act.[172] Although the court dismissed with prejudice plaintiffs' claims against Grant Thornton, in substantial

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[169] *Id.* at 12-13.
[170] *Id.* at 15.
[171] *Id.* at 14.
[172] 588 F. Supp. 2d 1132 (C.D. Cal. 2008).

part plaintiffs' claims otherwise survived the fifty defendants' motions to dismiss.

Due to the length of the opinion (112 pages), this summary will highlight the court's analysis of two areas: loss causation and scienter.

In looking at whether plaintiffs adequately plead loss causation, the defendants claimed that because corrective disclosures occurred over time, and at times along with other "misrepresentations that dampened the disclosures' price effects," that the plaintiffs had not met their pleading burden.[173] The court looked to the reasoning in *In re Gilead*,[174] where the court noted that disclosure of the misrepresentation need only be a substantial cause for the decline in value of the securities, and *In re Daou*,[175] where the court analyzed a series of partial disclosures, and noted that "showing loss causation is not precluded by a series of disclosures; serial disclosures just make it more difficult for plaintiffs as a practical matter."[176] The court found that because as Countrywide's disclosures accumulated, the price of its securities dropped, and those drops "correlate tightly" with most of the corrective disclosures, plaintiffs had adequately pleaded loss causation.[177]

For pleading scienter under Section 10(b), the court opted to analyze falsity together with scienter.[178] At the outset the court concluded that "[p]laintiffs have created a cogent and compelling inference of a company obsessed with loan production and market share with little regard for the attendant risks, despite the company's repeated assurances to the market."[179] The court paid

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[173] *Id.* at 1201.
[174] 536 F.3d at 1055.
[175] 411 F.3d at 1026.
[176] 588 F. Supp. 2d at 1200.
[177] *Id.* at 1201. This was with the exception of one individual defendant, Stanford Kurland, for whom the court found plaintiffs did not adequately plead loss causation because Kurland resigned in 2006, and the first corrective disclosure was not until 2007. *Id.*
[178] *Id.* at 1185.
[179] *Id.* at 1186.

particular attention to how Countrywide's loan origination practices changed over time in its analysis. For example, plaintiffs alleged that although it was "industry custom" to classify a loan to a borrower with a FICO score of less than 660 as "subprime," Countrywide employed a system whereby the definition of "prime" loosened over time, and at the end even included borrowers with FICO scores in the low 500s.[180] Countrywide failed to disclose its altered classification system to investors until a July 24, 2007 conference call.[181] The court determined that this practice was misleading, and because of this among other factors, the plaintiffs had adequately pleaded scienter.[182]

IX. Stock Options Backdating

Of the 39 stock options backdating class actions filed since 2006, eighteen settled, nine were dismissed and twelve remain pending.[183] Yet again, this past year saw a marked decrease in the number of stock options backdating-related securities class actions filed, with only four actions filed in 2008, and none in the first two quarters of 2009.[184] As with 2007, this past year has seen a number of significant settlements. Most notably, was the UnitedHealth class action settlement, in which the court approved a $895 million cash payment, including $30 million paid from and stock options to purchase more than 3 million UnitedHealth shares returned by UnitedHealth's former Chairman and Chief Executive William McGuire.[185] Other notable settlements during the year

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[180] *Id.* at 1147.
[181] 588 F. Supp. 2d at 1147. Note that the court found that plaintiffs did not adequately plead scienter with respect to Countrywide's auditor, KPMG, stating that the scienter allegations did not amount to much more than a negligence inference.
[182] *Id.* at 1186.
[183] RiskMetrics Group – Securities Class Actions Services, *Tracking the Federal Options Backdating Securities Class Actions*, available at http://slw.riskmetrics.com/Options_Backdating.pdf (last visited June 14, 2009).
[184] Stanford Law School Securities, Class Action Clearinghouse, Securities Class Action Filings, *supra* note 2.
[185] Tom Murphy, *Judge OKs $900 Million-Plus UnitedHealth Settlement Over Backdating*, www.law.com, (Dec. 19, 2008).

were Monster Worldwide Inc. ($47.5 million),[186] Amkor Technologies ($11.25 million)[187] and most recently Marvell Technology ($72 million).[188] With the absence of new filings, and with currently-filed cases winding down, it appears that the stock option backdating scandal has finally run its course.

Recent Cases of Note:

(1) Ninth Circuit

In *Rudolph v. UTStarcom*, plaintiff alleged that a stock option backdating scheme existed at UTStarcom, and that two press releases related to the alleged scheme caused UTStarcom's stock to lose substantial value.[189] Plaintiff filed claims under Sections 10(b), 14(a) and 20(a) of the Securities Exchange Act.[190] Defendants moved to dismiss plaintiff's second amended complaint after prevailing on an initial motion to dismiss. With respect to the Section 10(b) claims, the court examined the defendants' assertion that the second amended complaint failed to adequately plead loss causation and scienter. The court reconsidered its previous ruling that a November 2006 press release announcing an internal investigation into UTStarcom's stock option backdating practices showed loss causation. The court had earlier concluded that the announcement of an investigation alone was insufficient because the disclosure did not

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[186] Elizabeth Campbell, *Monster agrees to $47.5m settlement*, Boston.com, (Aug. 2, 2008), available at http://www.boston.com/business/technology/articles/2008/08/02/monster_agrees_to_475m_settlement/ (last visited June 14, 2009).
[187] Press Release, *Amkor Announces Agreement to Settle Class Action Securities Litigation*, available at http://www.amkor.com/index.cfm?objectid=26DA52D1-CCF9-8724-AFE43B9941B9545F (last visited June 14, 2009).
[188] *Marvell Settlement Adds to Backdating Class Action Tally*, Corporate Legal Times Magazine (June 14, 2009), available at http://www.cltmag.com/marvell-settlement-adds-to-backdating-class-action-tally.html (last visited June 14, 2009).
[189] No. C 07-04578 SI, 2008 U.S. Dist. LEXIS 63990, at *2 (N.D. Cal. Aug. 21, 2008).
[190] *Id.*

reveal that a restatement would be required.[191] The court previously relied on several cases that held that the mere announcement of an investigation was not sufficient and also relied heavily on the ruling in *In re Daou Systems, Inc.*, that loss causation was not pled during the period of time in which "the true nature of Daou's financial condition had not yet been disclosed."[192] The court concluded, however, that its perspective had changed due to the intervening Ninth Circuit opinion of *In re Gilead Sciences*[193]. The court stated that *Gilead* clarified that pleading loss causation required plaintiff to allege only "facts that, if taken as true, plausibly establish loss causation."[194] Moreover, the court noted that although the press release did not definitively state that a restatement would occur, it "put the market on notice that such disclosures would be forthcoming."[195] The market allegedly reacted with a substantial price decline. Based on these allegations, the court concluded that loss causation had been sufficiently pled.

Turning to scienter, the court previously held that the complaint "did not support a strong inference of scienter because it relied on numerous factual allegations that could equally support the inference that stock options had been backdated through innocent bookkeeping error."[196] Although the court previously found that statements of two confidential witnesses could have supported an inference of scienter it held that the complaint did not provide sufficient information about the witnesses and the basis for their statements.[197] The court concluded that plaintiff's amended complaint remedied the prior deficiencies by providing greater detail on the witnesses. The court concluded that the observations of one confidential witness, who purportedly saw one of the individual defendants backdating stock options as well as new allegations about the suspicious pattern of grants made to high-

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[191] *Id*., at *9.
[192] *Id.* at 1027.
[193] 536 F.3d 1049 (9th Cir. 2008).
[194] *Rudolph,* 2008 U.S. Dist. LEXIS 63990, at *11.
[195] *Id*., at *11-12.
[196] *Id.*, at *15.
[197] *Id.*

ranking executives during a particular time period, taken as a whole with, gave rise to a strong inference of scienter.[198]

Turning to the Section 14(a) claim, the court did not disturb its previous ruling that plaintiff had failed to allege that defendants' misleading statements or omissions were an "'essential link' in the accomplishment of the transaction proposed in the proxy statement."[199] Finally, the court denied defendants' motion to dismiss the Section 20(a) claim because the plaintiffs adequately alleged a primary violation of the federal securities laws and the defendants did not dispute that plaintiff had also alleged that defendants were control persons.[200]

In *In re Marvell Tech. Group Ltd. Secs. Litig.*, plaintiffs brought claims under Sections 10(b), 14(a) and 20(a) of the Securities Exchange Act, stemming from alleged stock option backdating practices.[201] There were several events pertaining to the alleged backdating that plaintiffs alleged caused Marvell's stock to drop: (1) Marvell was one of sixteen companies identified in a May 22, 2006, Merrill Lynch report suggesting that companies may have participated in backdating; (2) Marvell announced in a July 3, 2006 8-K filing that it was conducting an internal investigation related to stock option backdating and had received an inquiry letter from the SEC; (3) on October 2, 2006, Marvell issued a press release that measurement dates for some option grants likely differed from the recorded dates and that a restatement would likely be required and Marvell issued a second press release the same day stating that net revenue for 3QFY07 would be down 10% and expenses would be higher due to costs related to stock option grant accounting.[202] In its Form 10-K filed on July 2, 2007, Marvell announced that the Special Committee found that 74% of Marvell's option grants were backdated such that the "the original measurement dates were lower than the appropriate measurement dates for 97% of remeasured grants" and

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198 *Id.*, at *18.
199 *Id.*, at *20.
200 *Id.*
201 No. C-06-06286 RMW, 2008 U.S. Dist. LEXIS 84934, at *9 (N. D. Cal. Sept. 29, 2008).
202 *Id.*, at *5-7.

that certain meetings of the Stock Option Committee were false because no such meetings occurred.[203]

In looking at the Section 10(b) claim, the court found that the plaintiffs sufficiently allege scienter as to the company and all but one of the individual defendants because the Special Committee findings support scienter (the Special Committee determined that backdating occurred and that meeting minutes were fictionalized, and as a result, Marvell restated its financials and took remedial actions)[204] and the individual defendants' actions, looked at collectively for each individual defendant, supported an inference of scienter for all except for the director of Marvell's Executive Compensation Committee, Cioffi.[205] The court determined that the complaint did not adequately plead scienter as to Cioffi because allegations of Cioffi's membership in the Executive Compensation Committee, without specific allegations as to his actions, was not enough.[206]

In its analysis of loss causation, the court noted that even though the company's October 2, 2006, announcement that it was restating its financial was accompanied by another press release on the same day that Marvell would fail to meet its revenue targets, it was still reasonable to infer that "the revelation regarding the stock option accounting was significant" and could plausibly have "caused the drop in Marvell's stock price."[207] As such, the court declined to dismiss based upon failure to plead loss causation.

In *Middlesex Retirement System v. Quest Software, Inc.*, plaintiff brought suit against Quest Software, Inc. and several of its officers and directors, alleging violations of Sections 10(b), 20(a) and 20A arising out of the alleged backdating of stock options given to Quest employees pursuant to what Quest termed as its "bucket and best price" methodology.[208] Under the "bucket and

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[203] *Id.*, at *7.
[204] *Id.*, at *16-21.
[205] *Id.*, at *22-29.
[206] *In re Marvell Tech. Group*, 2008 U.S. Dist. LEXIS 84934, at *29-30.
[207] *Id.*, at *33.
[208] No. CV-06-6863 DOC (RNBx), 2008 U.S. Dist. LEXIS 68419, at *1-5 (C. D. Cal. July 10, 2008).

best price" methodology, Quest would identify the date in a particular time period when its stock price was the lowest and issue every option during that period "as of" the date of the lowest share price.[209] Plaintiff alleged that this practice violated both GAAP and Quest's own 1999 Stock Incentive Plan.[210] Quest eventually conceded that it knowingly backdated stock options, and restated its financials to reflect nearly $150 million of additional compensation expenses.[211]

In examining the plaintiff's scienter allegations under Section 10(b) as to the company and the named officers and directors (with the exception of defendant Jerry Murdock, Jr., an outside director for whom the court engages in separate analysis), the court acknowledged that it previously found that the allegations in the complaint gave rise to a "strong inference" that Quest "was engaging in substantial, prolonged, and intentional backdating of stock options," and that "Defendants either knew or were deliberately reckless in not knowing that the purported option grant dates were improper."[212] From this, the court next determined whether the Defendants had the requisite scienter as to the misleading SEC filings. Looking at five allegations as a whole -- (1) defendants' knowledge of Quest's intentional backdating; (2) defendants' repeated certifications that Quest's financial statements conformed with GAAP; (3) defendants' knowledge of Quest's 1999 stock incentive plan; (4) defendants' initial denial of wrongdoing and (5) Quest's former CFO's resignation in lieu of cooperating with the Special Committee -- the court found that the allegations supported a strong inference that defendants knew or were deliberately reckless in not knowing that their intentional backdating procedures rendered Quest's financial statements misstated.[213]

As to defendant Jerry Murdock, Jr., an outside director who did not receive any backdated stock options, the court found

[209] *Id.*, at *3.
[210] *Id.*, at *3-4.
[211] *Id*.
[212]*Middlesex Retirement System*, 2008 U.S. Dist. LEXIS 68419*Id.*, at *14 (internal quotation marks omitted).
[213] *Id.*, at *15-27.

that the plaintiff pleaded sufficient participation for Murdock to be liable as a participant in Quest's false SEC filings and sufficiently plead scienter because Murdock was alleged to be a member of Quest's Compensation Committee (which issued the backdated options), a member of Quest's Audit Committee (charged with certifying Quest's financial, reporting to Quest's board and reviewing SEC filings) and Murdock signed SEC filings and reports to the company's board which contained false statements.[214] The court continued, "Murdock was in a special position at Quest: he likely had more exposure to the option granting practices than any other individual defendant. As a consequence, he was uniquely situated to know that those practices were inappropriate."[215]

(2) Eleventh Circuit

In *Rosenberg v. Gould*, plaintiffs brought suit against Witness Systems, Inc., ten Witness officers and directors and an accounting firm under Sections 10(b) and 20(a) of the Securities Exchange Act for an alleged stock option backdating scheme.[216] The lower court granted defendants' motion to dismiss the complaint for failure to satisfy the standard for pleading scienter and loss causation with prejudice. Plaintiffs appealed the ruling only as to the company and David Gould, the company's former chief executive officer. [217]

The crux of plaintiffs' scienter allegations was that because Gould granted and received backdated stock options in 2000 and 2001, "he possessed fraudulent intent during the class period when he signed filings for the Securities and Exchange Commission and overstated earnings in announcements of quarterly results."[218] Similarly, the plaintiffs alleged with respect to the company that "because options were backdated in 2000 to 2001 and because backdating is inherently intentional, the

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[214] *Id.*, at *27-30.
[215] *Id.*, at *33.
[216] *Id*.
[217] 554 F. 3d 962, 964 (11th Cir. 2009).
[218] *Id.* at 965-66.

company intentionally misrepresented earnings in 2004 to 2006."[219] The court found that the allegations were "insufficient to establish an inference of fraudulent intent that is at least as compelling as any opposing inference of nonfraudulent intent."[220] After finding that scienter was not adequately pleaded, the court did not reach the question of whether the complaint met the standard for pleading loss causation. Finally, the court determined that there was no claim under Section 20(a) because the complaint failed to allege primary liability under Section 10(b).[221]

X. **Looking Forward**

The past year has seen a remarkable incongruity between the increasing tide of securities actions filed following a series of legal decisions by the Supreme Court restricting the ability of plaintiffs to bring such suits. The line of cases began with the 2005 opinion in *Dura Pharmaceuticals, Inc. v. Broudo*, where the Supreme Court admonished lower courts to remember that the federal securities laws were not created to "provide investors with broad insurance against market losses,"[222] and that it was important to require plaintiffs to plead and prove loss causation to prevent them from bringing groundless claims that force settlement through their *in terrorem* effect.[223] This was followed by *Credit Suisse Securities (USA) LLC v. Billing*, where the Supreme Court held that the federal securities laws preempted the antitrust laws as to the underwriting practices in connection with an IPO.[224] Among the bases for its decision, the Supreme Court found that "Congress, in an effort to weed out unmeritorious securities lawsuits, has recently tightened the procedural requirements that plaintiffs must satisfy when they file those suits. To permit an antitrust lawsuit risks circumventing these requirements by permitting plaintiffs to dress what is essentially a securities

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219 *Id.* at 966.
220 *Id.*
221 *Id*. at 967.
222 544 U.S. 336, 345 (2005)
223 *Id.* at 346.
224 551 U.S. 264, 282 (2007).

complaint in antitrust clothing."[225] *Credit Suisse* was followed by *Twombly*,[226]*Tellabs*[227] and *Ashcroft*,[228] all of which effectively increased the scrutiny that courts must pay to securities pleadings.

In the face of these restrictive rulings, it is counterintuitive that the pace of securities filings would increase. Yet this is exactly what occurred in 2008, and continues through 2009, even if on a slower track. Perhaps this incongruous result can best be explained by pointing to the confluence of factors that are driving filings today and into the future. A weakening economy has always been a driver for securities litigation. And always leave it to the creative plaintiffs bar to try to find ways to avoid or plead around these tightening standards.

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[225] *Id.*
[226] 550 U.S. 544 (2007).
[227] 551 U.S. 308 (2007).
[228] 129 S. Ct. 1937 (2009).