

Securities Litigation
Year in Review
2011

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Meet the Authors



Nicholas Even is Co-Chair of the firm's national Securities and Shareholder Litigation and Class Action Defense practices. From the Time-Warner-Paramount merger contest in 1989, to trying the first case of a triggered poison

pill in 2009, he has spent two decades litigating securities suits in state and federal courts across the country. In 2011, among other matters, he was defense counsel in Texas derivative litigation for the purchaser of Silverleaf Resorts in its acquisition by affiliates of Cerberus Capital Management, and represented Lextron, Inc. in Delaware and Texas shareholder class actions arising from its acquisition of Animal Health International.



Thad Behrens is Co-Chair of the firm's national Securities and Shareholder Litigation and Class Action Defense practices. He has successfully defended companies, as well as directors and officers, in securities class actions,

derivative suits, M&A litigation, and proxy contests. A major part of his practice also includes other types of class actions, including his current defense of a consumer class action against the National Football League and an environmental class action against BP Products North America, Inc. Thad is a past president of the Dallas Federal Bar Association, and regularly speaks and writes on shareholder litigation and class action issues.



George W. Bramblett, Jr. has been involved in high profile, high stakes litigation in Texas, with significant experience in the general area of securities and shareholder litigation. He was named in the 2012 edition of Best Lawyers in America,

including in following litigation areas: Bet-the-Company suits, Securities Regulation, Trust & Estates, ERISA, Commercial Litigation, and Legal Malpractice. He has been recognized by Chambers USA 2009–2011 as one of the leading practitioners in the United States for General Commercial Litigation.



Carrie Huff has more than 20 years of experience in class actions, shareholder/securities suits and fiduciary litigation. In 2011, she defended a broker-dealer firm sued under the Texas Securities Act for selling auction rate securities, and oil

and gas companies sued in a class action relating to accounting for Texas severance taxes. She also continued to represent the trustees of two family trusts involved in a high-profile, multi-court dispute. Carrie currently serves on the Council for the Texas State Bar Antitrust and Business Litigation Section.



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Dan Gold is a partner in the firm's Class Action and Securities and Shareholder Litigation practices. In 2011, among other matters, he represented affiliates of a hedge fund manager in a breach of fiduciary duty class

action arising out of the collapse of the fund, and defeated class certification in a lawsuit alleging that an out-of-state online college violated the Texas Education Code by enrolling Texas students. Dan serves as an officer of the Securities Section of the Dallas Bar Association, on the Regional Board of the Anti-Defamation League and in the leadership group for the Attorneys Division of the Jewish Federation of Greater Dallas.

Clients and Friends,

Welcome to the inaugural issue of Haynes and Boone's Securities Litigation Year in Review.

2011 was a remarkable year in the world of securities class actions, with notable decisions from the Supreme Court, and a number of interesting rulings from Circuit and District Courts as well. The Supreme Court issued three decisions covering important merits—and class certification-related issues in securities class actions, following two significant securities decisions in 2010. Three of these five decisions from the last two years could be characterized as “plaintiff-friendly”—from a Supreme Court generally considered to be “pro-business.” Although the numbers may vary among Circuits, the overall pace of securities class action filings will likely continue unabated. NERA's year-end review projects 232 securities class action filings in 2011, broadly in line with levels observed over the past three years.

2011 was a busy and successful year for Haynes and Boone's Securities Class Action Defense and Shareholder Litigation Practice Group. Our team spent the year defending claims arising out of the collapse of a hedge fund, lawsuits challenging M&A transactions, auction rate securities claims, and derivative litigation claiming breaches of fiduciary duty by directors. In addition, lawyers in our group continued to leverage our class action defense experience in representing clients facing class actions in the consumer, mass-tort, and other contexts.

We hope you enjoy this 2011 Securities Litigation Year in Review. We look forward to working with you in the future.

Nick Even and Thad Behrens
Co-Chairs
Securities Class Action Defense and Shareholder
Litigation Practice Group

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Class Certification: A Major Battleground

Haynes and Boone has successfully opposed class certification for more than a decade, challenging the conventional wisdom that securities fraud cases are nearly always well-suited for class treatment. e.g. *Umsted v. Intellect, Inc.*, 2003 WL 79750 (N.D. Tex. Jan. 7, 2003); *Krim v. pcOrder.com, Inc.*, 210 F.R.D. 581 (W.D. Tex. 2002). Those early challenges have proven prophetic, as class certification has developed into a major battleground in securities cases.

Among class certification decisions in 2011, the two most important for securities cases are the Supreme Court's decisions in *Wal-Mart* and *Halliburton*. Although not a securities case, *Wal-Mart* has potential implications for every class action and provides support for challenges to class certification in securities cases. *Halliburton* is uniquely relevant to securities class actions, addressing, but not necessarily resolving, a circuit split on the fraud-on-the-market theory that nearly every securities fraud plaintiff relies on in seeking certification of a class.

Wal-Mart and its Impact on Securities Class Actions

On June 20, 2011, the Supreme Court issued its much anticipated opinion in *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011), reversing a lower court decision certifying a nationwide class of 1.5 million female employees in a gender discrimination suit against Wal-Mart. In a 5-4 decision, the Court held that class certification was improper because the plaintiffs failed to show commonality—that there were “questions of law or fact common to the class.” In addition, a unanimous Court found that the plaintiffs’ claims for individualized monetary damages were improperly certified for class treatment under Rule 23(b)(2), applicable where “the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole.”

Wal-Mart, while most directly applicable to employment discrimination litigation, has aspects that are likely to impact the class certification analysis in securities cases. First, the Court's analysis of commonality may provide defendants with an opening to argue that a case does not involve questions of law or fact common to the class. Commonality has rarely been challenged in securities fraud cases, as it was thought that a single common question—such as whether defendants’ statements were false—would suffice to meet this requirement. The Supreme Court's decision in *Wal-Mart*, however, reframes the commonality issue as focusing on “common answers” rather than common questions. “Their claims must depend upon a common contention” and “must be of such a nature that it is capable of classwide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke.” In some securities cases, this standard may not be met. Take, for example, a case with an extended class period challenging different statements made at different times in the context of a different mix of public information. The answers to common questions—were the statements false, was the undisclosed information material to the market, was the truth already known—may not be the same for all members of the putative class.

Securities cases with extended class periods may not meet the “commonality” element as reframed by the Supreme Court in *Wal-Mart*.

In addition to its holding on commonality, *Wal-Mart* is instructive on the rigorous scrutiny that courts must apply before certifying a class action. *Wal-Mart* confirms that class certification requires

evidence, not mere allegations, that each of the class certification pre-requisites is met. *Wal-Mart* also eliminates any remaining doubt about whether a court can permissibly consider the merits of a case when deciding whether certification is appropriate. As the Supreme Court put it, “[f]requently that ‘rigorous analysis’ will entail some overlap with the merits of the plaintiff’s underlying claim. That cannot be helped....” In addition, *Wal-Mart* strongly suggests that the *Daubert* standards for the admission of expert testimony apply at the class certification stage. This is particularly important in securities cases, which often involve complex expert testimony on market efficiency and stock price movement. Securities fraud plaintiffs often attempt to avoid scrutiny of their expert’s work at the class certification stage, claiming that proffering an expert suffices to meet their burden or that any criticisms of an expert’s work are themselves common issues that do not defeat class certification. After *Wal-Mart*, there should be no dispute that defendants are free to challenge the admissibility of expert opinions and to defeat class certification if such opinions are unreliable.

Wal-Mart strongly suggests that the *Daubert* standards for the admission of expert testimony apply at the class certification stage.

Halliburton and the Continuing Fraud-on-the Market Circuit Split

On June 6, 2011, the Supreme Court unanimously held in *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. ___ (2011) that plaintiffs in a securities fraud case do not need to prove loss causation in order to rely on the fraud-on-the-market theory as a means of obtaining class certification. The Supreme Court’s narrow decision, however, left open a number of important questions on which the circuit courts continue to split.

At issue in *Halliburton* was the fraud-on-the-market presumption, which is the lynchpin for class certification in most securities fraud cases. In order to obtain class certification in most (if not all) cases seeking damages, a plaintiff must show that common issues predominate over issues that are individual to each potential class member. A class accordingly cannot be certified if each individual will have to prove reliance on the defendant’s alleged false statements, which is an essential element of a securities fraud claim. The most common way that plaintiffs seek to prove reliance on a class-wide basis is to take advantage of the fraud-on-the-market theory. Under this theory, permitted by the Supreme Court’s 1988 decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), plaintiffs need not show that they actually read or were aware of the defendants’ allegedly false statements. Instead, all purchasing shareholders can be presumed to have relied on the integrity of the company’s stock price, which plaintiffs argue was artificially inflated by the allegedly false statements. A defendant may rebut this presumption by any showing that severs the link between the alleged misrepresentation and either the price paid by the plaintiff or the purchase decision.

Before *Halliburton*, a circuit split had developed on how the fraud-on-the-market theory operates at the class certification stage. At one end of the spectrum was the Fifth Circuit, which required plaintiffs to prove that the defendants’ statements impacted the stock price in order to invoke the fraud-on-the-market presumption. This stock price impact is typically proven by showing that the stock price declined in response to the “truth” being revealed to the market, which mirrors the separate element of loss causation that a plaintiff must prove to obtain any recovery. The Fifth Circuit therefore held that plaintiffs must prove loss causation in order to obtain class certification. See *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007); see also *Archdiocese of Milwaukee*

Supporting Fund v. Halliburton Co., 597 F.3d 330 (5th Cir. 2010). In the middle are the Second and Third Circuits, which do not require plaintiffs to prove stock price impact to invoke the presumption, but expressly permit defendants to rebut the presumption at the class certification stage by showing the absence of price impact. See *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474 (2d Cir. 2008); *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623 (3d Cir. 2011). At the other end of the spectrum are the Seventh and Ninth Circuits, which while not expressly rejecting or adopting the middle-ground approach, have issued decisions that could be read as suggesting that defendants may not attempt to defeat class certification by showing the absence of price impact. See *Schleicher v. Wendt*, 618 F.3d 679 (7th Cir. 2010); *Connecticut Retirement Plans and Trust Funds v. Amgen, Inc.*, 2011 WL 5341285 (9th Cir. Nov. 8, 2011).

In *Halliburton*, the Supreme Court rejected the Fifth Circuit's rule, holding that proof of loss causation is not required to invoke the fraud-on-the-market presumption because reliance and loss causation are distinct requirements for a securities fraud claim. The Court explained that under the fraud-on-the-market doctrine, "an investor presumptively relies on a defendant's misrepresentations if that 'information is reflected in [the] market price' of the stock at the time of the relevant transaction." "Loss causation, by contrast, requires a plaintiff to show that a misrepresentation that affected the integrity of the market price also caused a subsequent economic loss." The Court held that the Fifth Circuit's rule contravened a fundamental premise of the fraud-on-the-market theory because "[t]he fact that a subsequent loss may have been caused by factors other than the revelation of a misrepresentation has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory." Defense counsel argued (correctly, in our view) that the Fifth Circuit's use of the phrase "loss causation" was "shorthand" for a price impact analysis, but the Supreme Court declined to consider that reading of the case.

While important, particularly in the Fifth Circuit, the decision in *Halliburton* was quite narrow. The Supreme Court made clear that it was ruling only on whether loss causation must be proven and expressly declined to "address any other question about *Basic*, its presumption, or how and when it may be rebutted." For example, *Halliburton* did not address (i) whether a plaintiff must prove that the false statements impacted the stock price in order to take advantage of the fraud-on-the-market theory, (ii) alternatively, whether a defendant can rebut the fraud-on-the-market presumption and defeat class certification by proving that the statements did not impact the stock price or were not material, or (iii) whether the fraud-on-the-market theory is rebuttable at the class certification stage or must await trial. Courts will continue to wrestle with these issues, with *Halliburton* providing each side with snippets to use as ammunition. Sooner or later, the issues that the Supreme Court declined to address in *Halliburton* may be back before the Supreme Court for resolution.

The decision in *Halliburton* was quite narrow. The issues that the Supreme Court declined to address in *Halliburton* may be back before the Supreme Court for resolution.



Janus Capital and the Line Between Primary and Secondary Liability

The Supreme Court's Decision in Janus Capital

In a June 13, 2011 decision, *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), the Supreme Court declined to broaden the judicially created private cause of action under Rule 10b-5. Its decision drew what it called a “clean line” between those who can be held primarily liable for securities laws violations in private lawsuits and those who cannot.

In *Janus*, investors sought to hold an investment adviser liable for misleading statements in prospectuses issued by a fund—a separate entity with its own board—managed by the adviser. The adviser was responsible for the operations of the funds and allegedly participated in preparing the relevant portion of the prospectuses.

The Supreme Court found that the plaintiffs had failed to state a claim against the adviser because the adviser could not be considered to have “made” the statements at issue. The Court held that the maker of a statement is “the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.” Because the prospectuses were filed by a separate legal entity and contained nothing attributing the statements to the adviser, the Court likened the adviser to a speechwriter rather than the entity with ultimate authority over the statements. A broader reading, the Court reasoned, would essentially eliminate the distinction between primary violators (against whom private lawsuits can be filed) and aiders and abettors (against whom only the SEC can bring suit). Rejecting the government’s argument that “make” should be defined as “create,” the Court refused to allow private suits against those who allegedly provide false information that another person then puts into a statement.

In *Janus*, the court refused to allow private suits against those who allegedly provide false information that another person then puts into a statement.

Application of Janus

Over the past six months district courts have begun to apply and interpret *Janus*. While the Supreme Court intended the decision to draw a clear distinction between primary and secondary liability, analysis of these district court decisions demonstrates that *Janus* left some unanswered questions for the lower courts to grapple with.

One key question that lower courts have begun to address is whether and how the “ultimate authority” rule of *Janus* applies to corporate officers.

Although *Janus* arose in the context of separate legal entities, most courts addressing the issue have found that *Janus* sets forth a legal standard that applies equally to claims against corporate officers. See, e.g., *Hawaii Ironworkers Annuity Trust Fund v. Cole*, 2011 WL 3862206 (N.D. Ohio Sept. 1, 2011) (“The [Supreme] Court’s interpretation of the verb ‘to make’...cannot be ignored simply because the defendants are corporate insiders.”). Further, where statements are attributed to an officer, courts generally have rejected the argument that only the corporation can be considered to have had ultimate authority. See *In re Merck & Co., Sec. Derivative & “ERISA” Litig.*, 2011 WL 3444199

(D.N.J. Aug. 8, 2011) (finding that the officer made the statements pursuant to his authority to act as an agent for the company and permitting a Rule 10b-5 claim to proceed against an officer); *Local 703 v. Regions Fin. Corp.*, 2011 U.S. Dist. LEXIS 93873 at *3 (“Nothing in *Janus* stands for the proposition that CEOs and CFOs cannot be liable for false and misleading statements in their own company’s financial statements...”).

So far, *whether Janus* should be applied to claims against corporate insiders appears to be less contentious than *how* it should be applied. Where the statements at issue are directly attributed to the officer, courts have little trouble finding that the officer is the “maker” of the statements. For example, *SEC v. Carter*, 2011 U.S. Dist. LEXIS 136599 (N.D. Ill. Nov. 28, 2011) (finding plaintiff had adequately alleged 10b-5 liability where it alleged that CEO defendant had approved the press releases in question, had signed an SEC form attaching one of the releases, and had been quoted in one of the releases); *Local 703*, 2011 U.S. Dist. LEXIS 93873 (N.D. Ala. Aug. 23, 2011) (finding defendants had ultimate authority over company’s financial statements, where defendants had signed Sarbanes-Oxley certifications).

In contrast, courts have applied *Janus* to dismiss claims against corporate officers where plaintiffs’ allegations do not show that the officer had ultimate authority over the statements at issue. In *Hawaii Ironworkers*, for example, plaintiffs alleged in the complaint that the defendants falsified financial statements but that the falsifications had been mandated by the company’s CEO and CFO, not the officers named as defendants. The Court thus found that defendants did not have ultimate authority over the statements. *See also In re Coinstar Inc. Sec. Litig.*, 2011 WL 4712206 (W.D. Wash. Oct. 6, 2011) (dismissing claims against officers for statements made by other executives at conferences).

Even in the context of separate legal entities (the context in which *Janus* arose), uncertainty in the lower courts has arisen from the *Janus* court’s statement that attribution “implicit from surrounding circumstances” is evidence of who made the statement. In *City of Roseville Employees’ Ret. Sys. v. EnergySolutions, Inc.*, 2011 WL 4527328 (S.D.N.Y. Sept. 30, 2011), a court in the Southern District of New York found questions of fact as to who had ultimate authority over the statement in question, despite the fact that the statements were issued by a legally separate entity (as they were in *Janus*). The Court cited the “surrounding circumstances,” including that the subsidiary was wholly owned by the parent and that registration statements contained such “indicia of control” as express statements that the parent would maintain control over certain matters. In contrast, just weeks after *City of Roseville*, a court sitting in the same district reached the opposite result on similar facts. *See In re Optimal U.S. Litig.*, 2011 WL 4908745 (S.D.N.Y. Oct. 14, 2011). While the *Optimal* court distinguished *City of Roseville* as involving stronger allegations of authority, it appears that the line between primary and secondary liability may not be as “clean” as *Janus* intended.

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Materiality: A Fact Intensive Inquiry

The Supreme Court's Decision in Matrixx Initiatives, Inc. v. Siracusano

In *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. ___, 131 S. Ct. 1309 (2011), the Supreme Court reaffirmed the prevailing test for materiality in a securities fraud action. Originally formulated in the *Basic* case, the test states that a disclosure is material where there is a substantial likelihood that the disclosure would alter, in the mind of a reasonable investor, the “total mix” of information available. *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Although courts have applied the “total mix” test for more than twenty years, it remains a fact-intensive inquiry that often hinges on the unique circumstances of a particular case. In *Matrixx*, the Supreme Court declined to adopt a bright-line rule for materiality.

According to the defendants, the facts of the *Matrixx* case made it suitable for a more measurable materiality analysis. The plaintiff investors claimed that the pharmaceutical company had failed to disclose harmful information about its cold remedy, Zicam. Specifically, they alleged that *Matrixx* had been aware of reports and complaints linking Zicam to anosmia, a loss of the sense of smell. *Matrixx* countered that the undisclosed information was not material because there was no showing of a statistically significant correlation between the use of Zicam and anosmia. The district court accepted *Matrixx's* argument and dismissed the complaint. However, the Ninth Circuit reversed, thereby creating a split with the First, Second, and Third Circuits.

In *Matrixx*, the Supreme Court declined to adopt a bright-line rule for materiality.

The Supreme Court granted *certiorari* in *Matrixx* on the question of whether a plaintiff can state a claim under Section 10(b) and Rule 10b-5 based on a pharmaceutical company's nondisclosure of adverse event reports even though the incidents are not alleged to be statistically significant.

In a unanimous opinion, the *Matrixx* Court resoundingly affirmed the Ninth Circuit's decision. Rather than adopt a bright-line rule relating materiality to statistical significance, the Court noted that both medical experts and regulators look beyond statistical significance to evaluate product safety. Therefore, the Court concluded, it follows that a reasonable investor may also look beyond statistical significance in making a decision to purchase stock. The Court cautioned that its opinion did not mean that statistical significance is irrelevant in the materiality inquiry. Rather, the “fact-specific” nature of the inquiry requires courts to consider the source, content, and context of adverse incident reports in addition to their statistical significance.

Applying the “total mix” standard to the facts of the case, the Court then determined that the investors had adequately pleaded materiality. The Court noted that the complaint included reports about more than ten patients who had lost their sense of smell after using Zicam. The complaint also alleged that two medical experts had alerted *Matrixx* to the possibility of a link between Zicam and anosmia. Consequently, the Court held that the investors had pled sufficient facts to allege materiality and survive a motion to dismiss.

The Effects of Matrixx

In the months following *Matrixx*, circuit and district courts have expounded on the Supreme Court's analysis. Many courts have cited *Matrixx* as simply the most recent iteration of the standard materiality analysis required under *Basic* in securities fraud cases. See, e.g., *Silverman v. Motorola, Inc.*, 2011 U.S. Dist. LEXIS 80900, at *28 (N.D. Ill. July 25, 2011); *In re Boston Scientific Corp. Sec. Litig.*, 2011 U.S. Dist. LEXIS 106042, at *25 (D. Mass. Sept. 19, 2011); *In re Sanofi-Aventis Sec. Litig.*, 774 F. Supp. 2d 549, 563 n.9 (S.D.N.Y. 2011). Other courts have emphasized that *Matrixx* did not broaden a corporation's disclosure requirements. See e.g., *Hill v. Gozani*, 651 F.3d 151, 152 (1st Cir. 2011) ("[T]he Court specifically reaffirmed the long-standing rule that the possession of material, non-public information does not create an automatic duty to disclose."). These decisions have confirmed that the materiality analysis after *Matrixx* is generally the same as it was before *Matrixx*.

However, there are certain aspects of materiality that may continue to challenge courts. Two recent cases highlight the difficulties of bright-line measures of materiality. In *Litwin v. Blackstone Group, L.P.*, 634 F.3d 706 (2d Cir. 2011), the Second Circuit considered whether certain omissions in a registration statement were material to investors. Before conducting its analysis, the Court acknowledged its prior acceptance of a 5 percent threshold as a "preliminary assumption" of immateriality. Nevertheless, even though a particular investment represented only 0.4 percent of the defendant's total assets, the Court determined that the defendant had omitted material facts related to the investment. Specifically, the Court found that the defendant failed to disclose trends related to the investments that suggested that the investments' performance would materially impact future revenues of the company. The *Litwin* decision predates the *Matrixx* decision, so it was not required to address the Supreme Court's repudiation of bright-line tests for materiality.

Post-*Matrixx*, however, the Second Circuit accepted a quantitative materiality inquiry in *Hutchison v. Deutsche Bank Sec. Inc.*, 647 F.3d 479 (2d Cir. 2011). The Court noted that the company's potential losses from certain loans fell well short of its 5 percent threshold for materiality and therefore concluded that the loans were not material. The *Hutchison* court makes no reference to the *Matrixx* decision, suggesting it may view its holding as limited to the pharmaceutical context. Recognizing a possible contradiction with its earlier *Litwin* holding, however, the Court reconciled the two approaches as follows: "If a particular product or product line, or division or segment of a company's business, has independent significance for investors, then even a matter material to less than all of the company's business may be material for purposes of the securities laws."

Materiality remains a fact-intensive inquiry under *Basic* which requires courts to analyze all factors that would affect the decision of a reasonable investor. As the *Litwin* and *Hutchison* decisions demonstrate, courts will continue to differ about how much weight to assign quantitative thresholds versus qualitative facts.



Scienter: Continuing to Apply *Tellabs*

One of the essential elements of a securities fraud claim is scienter, which is a mental state involving either an intent to "deceive, manipulate, or defraud" or "severe recklessness." Federal law mandates a heightened pleading standard in federal securities fraud cases, including the requirement that a securities fraud complaint allege facts giving rise to a "strong inference" that the defendant acted with scienter. Federal courts in 2011 continued to apply the Supreme Court's now four-year-old decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007), which

held that the requisite strong inference of scienter means an inference that is “cogent and at least as compelling as any opposing inference of nonfraudulent intent.”

In *Frank v. Dana Corporation*, 646 F.3d 954 (6th Cir. 2011), the Sixth Circuit applied a “holistic approach” to reviewing scienter pleadings and held that the plaintiffs’ allegations, when viewed holistically, supported a strong inference of scienter. The Court expressly declined to follow its past approach of sorting through each scienter allegation individually before concluding with a collective approach. As support for its new holistic approach, the Sixth Circuit looked to the recent Supreme Court decision in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S.Ct. 1309, 1324 (2011) (quoting *Tellabs*, 561 U.S. at 326), in which the Supreme Court repeated its prior statement from *Tellabs* that a court must review scienter allegations “holistically.” The *Frank* decision is notable because some post-*Tellabs* decisions by other federal courts have applied the Sixth Circuit’s prior approach of first sorting through each scienter allegation individually before concluding with a collective approach.

In *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Waters Corp.*, 632 F.3d 751 (1st Cir. 2011), the First Circuit considered the relationship between scienter and the materiality of undisclosed information. At issue was whether the defendants intentionally or recklessly failed to disclose a change in regulations that reduced demand for their company’s products and services in Japan. The key issue in the case was not whether the defendants had knowledge of the change in regulations, but whether the defendants knew that their failure to disclose these changes presented a danger of misleading buyers and sellers. The Court held that, viewed objectively, the inferences were stronger that the defendants did not reasonably expect that the change in Japanese regulations would have a significant impact on the company’s overall worldwide sales, such as to require disclosure. As noted in the *Dearborn* decision, “[i]f it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that the defendants acted with the requisite intent or extreme recklessness in not disclosing the fact.”

In *City of Roseville Employees’ Retirement System v. Horizon Lines, Inc.*, 2011 WL 3695897 (3d Cir. Aug. 24, 2011), the Third Circuit affirmed the district court’s dismissal of claims against both individual and corporate defendants. Although certain low-level managers of the company had acted with scienter, they did not make any material false statements on which the plaintiff relied. As for the senior executives who made allegedly materially false statements, the Third Circuit concluded that the plaintiff had not pleaded sufficient facts to raise a strong inference of scienter. The company’s scienter therefore could not be based on the scienter of any individual. Without deciding whether it were possible to plead scienter against a corporation without pleading scienter against an individual, the Third Circuit held that the facts as alleged by the plaintiff could not survive a motion to dismiss. The *Rosewood* decision underscores that a showing of scienter, without a showing of the other requisite elements, is insufficient to establish a defendant’s liability for securities fraud.

The Second Circuit’s decision in *Fait v. Regions Financial Corp.*, 655 F.3d 105 (2d Cir. 2011), though not addressing the element of scienter, dealt with statements of subjectively held opinions and beliefs. The plaintiff in *Fait* had asserted claims under the federal securities laws that did not require proof of scienter. But the plaintiff’s allegations that the defendant made negligently false and misleading statements concerning “goodwill” and “loan loss reserves” were matters of opinion, for which “liability lies only to the extent that the statement was both objectively false and disbelieved by the defendant at the time it was expressed.” The Second Circuit affirmed dismissal of the plaintiff’s claims, holding that the complaint did not plausibly allege subjective falsity. Although the standard applied in *Fait* did not amount to a requirement of scienter, the decision nonetheless demonstrates that a defendant’s state of mind is a component of assessing whether statements of opinion and belief are not actionable.



Confidential Witnesses: Post-Discovery Challenges

To surmount the rigorous pleading requirements for a securities fraud complaint, plaintiffs will often attribute statements in the complaint to various confidential witnesses. When discovery unearths discrepancies between the witnesses' sworn testimony and statements attributed to them in the complaint or reveals inaccuracies with other confidential witness allegations (such as their position at the company), defendants sometimes attempt to discredit the plaintiffs' case or even sanction the plaintiffs or their counsel. Two cases in 2011 yielded differing results after defendants raised confidential witness discrepancies with the courts.

Dismissal Arising from Discredited Confidential Witness Allegations

The plaintiffs in *City of Livonia Employees' Retirement System v. Boeing Co.*, 2011 WL 824604 (N.D. Ill. Mar. 7, 2011), brought a securities fraud class action alleging that Boeing and two of its officers and directors misled investors concerning the testing and delivery schedule for Boeing's 787 Dreamliner based on knowledge top executives allegedly acquired in April to May 2009. The court dismissed the amended complaint without prejudice because the amended complaint failed to raise a strong inference of scienter. Based on Seventh Circuit precedent, the court severely discounted all the statements attributed to confidential witnesses because the amended complaint lacked particularized information concerning how any anonymous source was in a position to know about defendants' knowledge and intent. Plaintiffs filed a second amended complaint that added details about one confidential witness, whom plaintiffs alleged was a "senior Boeing engineer" and had first-hand knowledge of the 787 Dreamliner test results in documents circulated to top Boeing executives in April and May 2009. The court expressly relied on these new allegations in denying defendants' renewed motion to dismiss.

When discovery unearths discrepancies between the witnesses' sworn testimony and statements attributed to them in the complaint, defendants sometimes attempt to discredit plaintiffs' case or even sanction the plaintiffs or their counsel.

When discovery commenced, plaintiffs disclosed the identity of this confidential witness as Bishnujee Singh. Backed by declarations of those who oversaw Singh's work at Boeing, the defendants filed a sanctions motion requesting dismissal of the lawsuit based on the court's inherent power to sanction fraud and Federal Rule of Civil Procedure 11 (which requires a reasonable basis for allegations). Defendants asserted Singh was never a Boeing employee, but only an outside contractor who could not have possessed the inside knowledge alleged. The court denied the sanctions motion because it found plaintiffs' counsel appeared to have a good faith belief in the allegations from investigators' notes. The defendants later interviewed Singh and deposed him. Singh denied that he was the source of information in the second amended complaint. He denied having been employed by Boeing, and confirmed that he worked for an outside contractor beginning in August 2009, after the April–May 2009 time frame in which Boeing executives allegedly acquired the relevant knowledge. Singh attested that he never met plaintiffs' counsel until his deposition, nor was he shown the allegations attributed to him in the second amended complaint until his defense counsel interview. Based on this testimony, defendants filed a motion for reconsideration on their motions to dismiss and for sanctions, asserting

a fraud on the court. Defendants couched their motion to reconsider in terms of the court's "manifest errors" of fact in its previous rulings based on plaintiffs' counsel's misrepresentations. In response, plaintiffs' counsel admitted that the complaint incorrectly identified Singh as a senior Boeing engineer and that Singh was actually a line engineer for an outside contractor three to four months after the events at issue.

The court granted the motion and dismissed the second amended complaint with prejudice. The court concluded that if these facts had been disclosed while the dismissal motions were pending, the court would have disregarded the statements attributed to Singh and dismissed the complaint. The court faulted plaintiffs' counsel for failing to conduct a proper investigation into the veracity of the statements attributed to Singh, used to survive a motion to dismiss. Although some basis for these statements were contained in plaintiffs' investigators' notes, the court found that the notes otherwise indicated that information allegedly provided by Singh was unreliable. The court found plaintiffs' counsel should have followed up with Singh before attributing statements to him in the complaint.

City of Livonia's greatest significance is that it paves the way for a district court to reconsider a previously denied Rule 12(b)(6) motion to dismiss on the basis that the court committed a "manifest error" by relying on confidential witness allegations in the complaint that are later shown to be false. Although the court in *City of Livonia* drew attention to plaintiffs' counsel's failure to verify investigators' notes for key allegations in the complaint, the crux of the court's holding—that it committed a "manifest error" by relying on false allegations supporting the credibility of a confidential witness—would likely have stood even if plaintiffs had made pre-suit efforts to verify those facts. In other words, compliance with Rule 11 requirements in pleading confidential witness statements may not prevent reconsideration of a motion to dismiss where critical allegations supporting these statements are proven to be false during discovery.

Compliance with Rule 11 requirements in pleading confidential witness statements may not prevent reconsideration of a motion to dismiss where critical allegations supporting these statements are proven to be false during discovery.

Unsuccessful Challenge to Confidential Witness Allegations

In re Dynex Capital, Inc. Sec. Litig., 2011 WL 2581755 (S.D.N.Y. Apr. 29, 2011) adopted by district court 2011 WL 2471267 (S.D.N.Y. June 21, 2011), demonstrates some of the difficulties defendants face in attempting to seek sanctions against plaintiffs and their counsel for improper confidential witness statements in a complaint. The securities claims in *Dynex* focused on allegedly fraudulent statements concerning the quality of mobile home loans that served as collateral for bonds that Dynex originated and serviced. In denying defendants' motion to dismiss, the district court relied heavily on allegations purportedly derived from statements by nine confidential witnesses. After the court ordered plaintiffs to disclose the identity of the confidential witnesses during discovery, defendants interviewed them and discovered that five of the nine witnesses denied having made the statements attributed to them, and a sixth claimed no recollection of having made the statements. Four stated that, regardless of who made the statements, they did not believe the substance to be true. Defendants reduced the positions of these six individuals to declarations and submitted them in support of a motion to dismiss, based upon the court's inherent authority to sanction fraudulent conduct. Plaintiffs' counsel submitted declarations

from three attorneys who interviewed the six witnesses, claiming that all statements attributed to the six witnesses accurately reflected their interviews. The district court referred the sanctions motion to a magistrate and certified a class while the motion was pending.

The magistrate judge noted that he was presented with “a collection of competing declarations” and that imposing sanctions based on the court’s inherent authority required proof of fraud by clear and convincing evidence. The court found the competing submissions precluded such a finding. It was also important to the court that defendants’ assertion of fraud was uncorroborated by other evidence, and distinguished *City of Livonia* in which defendants had shown that the witness did not have the position that the complaint alleged. The court found “plausible” plaintiffs’ assertion that “some of the [confidential witnesses] may now be denying that they made negative statements about Dynex, so as to remain in the good graces of their former employer.” The court said it did not accept this counter-narrative as true, but it was plausible enough to prevent a finding of fraud by clear and convincing evidence. The district court accepted in full the magistrate’s report and recommendation.

Although rejecting a sanctions motion superficially similar to the one granted in *City of Livonia*, the facts in *Dynex* were quite different. First, the sanctions motion in *Dynex* was unaccompanied by a motion to reconsider. The focus was therefore on whether there had been misconduct rather than the reliance the court had previously placed on the confidential witness allegations. Secondly, in *Dynex*, despite the statements of these six individuals, other discovery independently suggested that the statements in the complaint attributed to the confidential witnesses could be true. Moreover, not all of the original nine confidential witnesses used by plaintiffs claimed that statements attributed to them were false. Because plaintiffs cited all nine confidential witnesses to establish the same basic point, it is possible that plaintiffs would have survived a motion to dismiss even without the statements of witnesses who later repudiated the allegations. Lastly, the defendants’ sanctions motion relied on the court’s inherent authority to punish fraud. Unlike Rule 11 sanctions, which only require a showing that plaintiffs’ pre-filing investigation into the facts was objectively unreasonable, sanctions based on the court’s inherent authority require defendants to prove a fraud on the court by clear and convincing evidence. The difference in the evidentiary burden may further explain the different results in these two cases.



Loss Causation: Very Technical, But Very Important

To plead and prove loss causation, securities fraud plaintiffs must show that they suffered economic losses that were caused by the defendants’ alleged fraud. Since the Supreme Court’s 2005 decision in *Dura Pharmaceuticals*, loss causation has become a prominent feature of securities fraud defendants’ litigation arsenal at virtually every stage of a case. In *Dura*, the Supreme Court held that plaintiffs could not show loss causation by pleading (and later proving) that they purchased stock at a price that was artificially inflated by the alleged fraud. It is not until the truth is revealed, usually through some sort of corrective disclosure, that the alleged fraud causes an actual economic loss. In addition to the Supreme Court’s *Halliburton* decision addressing loss causation at the class certification stage (discussed above), courts in 2011 continued to issue interesting opinions on the requirements for pleading and proving this causal connection.

Drawing Careful Distinctions

Courts continue to require plaintiffs to carefully distinguish between losses caused by the alleged fraud and losses caused by other factors. In *Borno v. General Electric*, 2011 WL 5607137 (2d Cir. Nov. 18, 2011), for example, the Second Circuit affirmed a dismissal for failure to plead loss causation in a case

alleging that defendants made misstatements concealing the risk that GE would issue new equity. The court carefully distinguished between two different pieces of information—the fact of the offering (the risk of which plaintiffs claimed had been concealed) and the price of the offering (which plaintiffs did not claim had been concealed). While the stock price had declined when the *price* of the offering was disclosed, it had increased when *the fact* of the offering had been revealed. Since no loss was caused by the materialization of the precise risk that plaintiffs claimed had been concealed, the court affirmed dismissal for failure to plead loss causation. Other decisions in 2011 by the Circuit Courts similarly held that loss causation was not shown where the negative information characterized by plaintiffs as the “truth” did not directly relate back to the allegedly false statements. *Katyle v. Penn National Gaming, Inc.*, 637 F.3d 462 (4th Cir. 2011) (disclosures of information related to status of leveraged buyout “did not even inferentially suggest” that earlier statements regarding buyout were false); *Amorosa v. AOL Time Warner Inc.*, 409 Fed.Appx. 412, 2011 WL 310316 (2d Cir. Feb. 2, 2011) (alleged corrective disclosures did not address accounting practices or auditor’s clean audit opinion). These cases reflect that courts will reject overly broad efforts to characterize negative information as being corrective of the alleged fraud, even at the pleading stage.

The post-trial decision in *In re BankAtlantic Bancorp, Inc.*, 2011 WL 1585605 (S.D. Fla. April 25, 2011) demonstrates the complexity of proving loss causation at trial. In *BankAtlantic*, the plaintiffs claimed that the defendant company made fraudulent statements about both its “builder land bank” (or BLB) loans and its non-BLB loans. The jury found fraud only as to the non-BLB loans, but the testimony of plaintiffs’ causation and damages expert had been premised on the assumption of fraud as to both categories of loans. Since the corrective disclosure had included negative information about both the BLB loans and the non-BLB loans, the court found that the failure of the plaintiffs’ expert to disaggregate the loss caused by the two categories of information meant that there was no adequate basis for the jury’s finding of causation and award of damages. The court therefore granted defendants’ motion for judgment as a matter of law. (The ruling is currently on appeal).

Courts continue to require plaintiffs to carefully distinguish between losses caused by the alleged fraud and losses caused by other factors.

The Booster Shot Theory of Price Inflation

Courts have split on whether the loss causation requirement is met in situations where the alleged misstatement did not result in an increase in the company’s stock price, but rather allegedly kept the stock price from decreasing as it otherwise would have.

In 2011, the Eleventh Circuit deepened this split of authority with its decision in *Findwhat Investor Group v. Findwhat.com*, 658 F.3d 1282 (11th Cir. 2011). The district court in *Findwhat.com* granted summary judgment in defendants’ favor after the plaintiffs’ expert opined that the company’s stock price was inflated before the first actionable misrepresentation and remained inflated at the same level after defendants made the two allegedly actionable misstatements. The Eleventh Circuit reversed, holding that “[f]raudulent statements that *prevent* a stock price from falling can cause harm by *prolonging* the period during which the stock is traded at inflated prices. We therefore hold that confirmatory information that wrongfully *prolongs* a period of inflation—even without increasing the *level* of inflation—may be actionable under the securities laws.” In so holding, the Eleventh Circuit noted that its decision appears to conflict with Fifth Circuit case law holding that confirmatory information—information already known

to the market—does not impact stock prices and is not actionable under a fraud-on-the-market theory. With conflicting circuit court authority, this issue will likely continue to divide district courts.

Loss Causation in Mutual Fund Cases

Another issue which has divided courts in 2011 is how loss causation principles apply to mutual funds. The issue arises because a fund's net asset value (NAV) is calculated by reference to the assets held by the fund rather than through market securities trading.

In *In re State Street Bank & Trust Co. Fixed Income Funds Investment Litig.*, 2011 WL 1206070 (S.D.N.Y. March 31, 2011), the Court granted a motion to dismiss claims under Sections 11 and 12 of the Securities Act of 1933 holding that the absence of loss causation (an affirmative defense to such claims) was apparent on the fact of the complaint. The Court "somewhat reluctantly" agreed that because of how NAV is calculated any alleged misrepresentations regarding a fund's investment objectives have no effect on a fund's share price. Any loss suffered by investors accordingly was not caused by defendants' alleged misstatements.

In contrast, this reasoning was rejected by the court in *In re Oppenheimer Rochester Funds Group Sec. Litig.*, 2011 WL 5042066 (D. Col. Oct. 24, 2011). At the motion to dismiss stage, the court refused to find that defendants had proven that alleged misstatements in the prospectus caused no loss to investors: "The fact that the pro rata 'price' of a mutual fund's aggregate holdings is set by mathematical formula rather than the actual market does not mean that the underlying value of those aggregated holdings cannot be squandered or diminished (and thereby reflected in NAV) by actions or materializations of risk about which purchasers of fund shares have been misled." The court did, however, caution plaintiffs that loss causation is a potentially dispositive issue at a later stage in the litigation.

VII

The Extraterritorial Reach of the U.S. Securities Laws: the Courts Apply *Morrison*

In 2010, the Supreme Court decided the landmark case, *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), in which it held that Section 10(b) of the Exchange Act does not apply extraterritorially and instead applies only to domestic securities transactions. *Morrison* was a so-called "foreign cubed" case—a claim (1) by a foreign plaintiff (2) against a foreign issuer (3) based on a securities transaction on a foreign exchange. Emphasizing that the focus of the Exchange Act is on security purchases and sales occurring within the United States, the Court adopted a bright-line "transactional test." Under the "transactional test," Section 10(b) applies only where the security at issue is (1) listed on a domestic stock exchange or, (2) if not listed on a domestic stock exchange, where its purchase or sale is made in the United States—regardless of whether the underlying fraudulent conduct occurred in or affected the United States. The Court reasoned that the bright-line "transactional test" rule would avoid "the problem of interference with foreign laws that application of Section 10(b) abroad would produce."

Courts are broadly applying *Morrison* consistent with the spirit of limiting the reach of the U.S. securities laws to foreign transactions.

2011 provided district courts with their first full year to digest, analyze, and apply the *Morrison* decision and a common theme emerged—courts are broadly applying *Morrison* consistent with the spirit of limiting the reach of the U.S. securities laws to foreign transactions. For example, district courts have rejected technical arguments that seek to circumvent *Morrison's* holding that the location of the securities transaction is determinative. In several cases, plaintiffs seized on Justice Scalia's language from the *Morrison* opinion that Section 10(b) applies to "securities listed on domestic exchanges." These plaintiffs

argued that their foreign-cubed cases were not foreclosed by *Morrison* because the securities that they purchased on foreign exchanges were also cross-listed on United States exchanges, for example, as American Depository Receipts (“ADRs”) or Global Registered Shares (“GRSs”). District courts roundly rejected this argument—Section 10(b) applies only to purchase and sale transactions that are executed on domestic exchanges or are otherwise made in the United States and not to all securities that also happen to be dually listed on a United States exchange. As the district court in *In re UBS Sec. Litig.* noted, a theory under which a Section 10(b) suit “could be brought by any plaintiff who purchased stock on any securities exchange against any issuer, as long as the stock at issue was cross-listed on an American exchange...would be utterly inconsistent with the notion of avoiding the regulation of foreign exchanges.”

Similarly, district courts have extended the holding of *Morrison* to foreign-squared cases—claims on behalf of *U.S. investors* who purchase securities from a foreign company on a foreign exchange. While the Supreme Court in *Morrison* did not define the phrase “domestic transactions,” district courts have held that the phrase was intended to be a reference to the transaction location and not to the location of the purchaser. Thus, investors must take heed—the fact that an investor from within the United States places an electronic order, or issues a purchase order, to purchase a security from a foreign issuer on a foreign exchange will not bring that transaction under the protection of Section 10(b) or otherwise shield that investor’s Section 10(b) claims from dismissal under *Morrison*.

District courts have also broadly applied the *Morrison* holding to include derivative instruments that reference foreign securities. For example, the plaintiffs in *Elliott Associates v. Porsche Automobil Holding SE*, 759 F. Supp. 2d 469 (S.D.N.Y. 2010), argued that *Morrison* did not foreclose their 10(b) claims because they signed confirmations for securities-based swap agreements (which referenced the share price of Volkswagen) in New York and, therefore, engaged in “domestic transactions in other securities.” The district court rejected this argument and held that the plaintiffs’ swap agreements were economically equivalent to the purchase of VW shares on a German exchange. Accordingly, the economic reality of the transaction was that the plaintiffs’ swap agreements were essentially “transactions conducted upon foreign exchanges and markets,” and not “domestic transactions” that would merit the protection of Section 10(b). The Court was “loathe to create a rule that would make foreign issuers with little relationship to the U.S. subject to suits [in the United States] simply because a private party in this country entered into a derivatives contract that references the foreign issuer’s stock.”

While *Morrison* dealt with a security traded on a foreign exchange, what about situations involving securities not traded on any exchange, such as CDOs? In these situations, district courts must determine whether a securities transaction satisfies the second prong of *Morrison*—that is, whether the securities transaction constituted a “purchase or sale...made in the United States.” This analysis necessarily requires courts to define *when* a purchase or sale occurred so that it can then determine *where* the transaction took place. In 2011, several district courts adopted the rule that, for purposes of the Exchange Act, an individual becomes a purchaser when he or she incurs an irrevocable liability to take and pay for a security. Similarly, an individual becomes a seller at the moment in time when he or she incurs irrevocable liability to deliver a security. But the contours of these rules have yet to be fully developed. While district courts have noted that the location of the closing of the transaction is not necessarily determinative of when a purchase or sale occurred, the district court in *Quail Cruises Ship Management Ltd. v. Agencia de Viagens CVC Tur Limitada*, 645 F.3d 1307 (11th Cir. 2011), held that because the purchase and sale agreement to the securities at issue confirmed that it was not until the domestic closing that title to the shares was transferred to the plaintiff, and because the domestic closing occurred in Miami, Florida, the plaintiff had sufficiently alleged that the “purchase or sale” had occurred in the United States. The issues of when the “purchase or sale” of a security not listed on an exchange occurred, and, accordingly, whether that purchase or sale occurred in the United States, will likely be among the most analyzed extraterritoriality issues in 2012.

VII

Duty to Disclose: When Is Disclosure Required?

In *Matrixx*, the Supreme Court upheld another *Basic* premise: there is no general duty to disclose material information. Rather, disclosure is required only when necessary to make statements not misleading in light of the circumstances under which they were made. Two recent circuit court decisions help illustrate this component of the *Matrixx* case.

In *Hill v. Gozani*, 651 F.3d 151 (1st Cir. 2011), the First Circuit affirmed the dismissal of a securities fraud case against a medical technology company and its executives. The plaintiffs had alleged that the executives had withheld internal dissenting opinions about the company's reimbursement strategy. First, the Court noted that *Matrixx* "specifically reaffirmed the long-standing rule that the possession of material, non-public information does not create an automatic duty to disclose." The Court then distinguished *Matrixx* by noting that the omissions in that case contradicted the company's express representations about the safety of its product. By contrast, in the *Hill* case, the company specifically identified the risks associated with nonreimbursement. As a result, the First Circuit held that the internal dissenting opinions were not a material omission.

The Eighth Circuit reached a similar conclusion in *Minneapolis Firefighters' Relief Ass'n v. MEMC Elec. Materials, Inc.*, 641 F.3d 1023 (8th Cir. 2011). In that case, the plaintiffs alleged that the defendant company withheld certain disclosures about incidents at one of its manufacturing plants. Specifically, the plaintiffs argued that the company's previous "pattern" of disclosing manufacturing disruptions rendered its subsequent press releases and financial statements misleading for failure to disclose this more recent incident. The district court dismissed the complaint after finding that the company had no duty to disclose the production disruptions.

On appeal, the Eighth Circuit affirmed the dismissal. The court noted that companies are not required to make continuous disclosures. Rather, absent a duty to disclose, companies may choose to remain quiet about bad news as well as good news. The court further noted that the holdings in *Matrixx* did not change this basic rule. Therefore, the Eighth Circuit declined to extend the duty to disclose to circumstances where a company had exhibited a "pattern" of previous disclosures. Because the defendant company had not made any misleading representations about the production capacity of this plant, it did not have a duty to disclose the disruptions.

There is no general duty to disclose material information. Disclosure is required only when necessary to make statements not misleading in light of the circumstances under which they were made.

IX

Standing: Who Can Bring Suit?

Courts continue to carefully scrutinize whether plaintiffs have a sufficient actual interest in litigating each of the claims asserted. For example, in the class action context, the First Circuit dismissed securities claims asserted against six of eight defendant trusts where the named plaintiffs did not purchase mortgage-backed securities issued by those six defendants. *Plumber's Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762 (1st Cir. 2011). The First Circuit concluded that the named plaintiffs held no stake in establishing liability for misconduct relating to the sale of certificates that the named plaintiffs did not purchase and therefore, the named plaintiffs lacked standing to assert claims against those defendants. Because the named plaintiffs lacked standing, the court also determined that the named plaintiffs could not seek relief on behalf of any member of the class against the six defendant trusts from whom the named plaintiffs purchased no certificates.

In upholding the lower court's dismissal, the First Circuit resolved what it perceived to be an unsettled standing issue. The court recognized that although no Supreme Court holding directly resolved the standing issue, the First Circuit relied upon *Barry v. St. Paul Fire & Marine Ins. Co.*, 438 U.S. 531 (1978) (affirming 555 F.2d 3 (1st Cir. 1977)). Applying *Barry*, the First Circuit affirmed the dismissal of claims against the six defendant trusts in the *Nomura* case because the named plaintiffs did not purchase any of those defendants' certificates.

Although the First Circuit ultimately held that the *Nomura* named plaintiffs lacked standing to assert class action claims against the six defendant trusts, it did indicate a possible caveat to that holding. The court surmised that it may have reached a different holding if the named plaintiffs' claims gave them the same incentive to litigate the class members' claims. The same incentive to litigate arises when the named plaintiffs' claims necessarily establish those of the other class members. However, the First Circuit found this situation did not exist in *Nomura* because no named plaintiff had a significant interest in establishing wrongdoing by a bank (or trust) from which he purchased no certificates.

In *In re Enron Corp. Sec., Derivative & ERISA Litig.*, MDL 1446, 2011 WL 5967239 (S.D. Tex. Nov. 29, 2011) a federal district court in Texas analyzed plaintiffs' standing to assert claims related to debt securities issued by Enron. The plaintiffs sued JPMorgan Chase & Co, Credit Suisse First Boston Inc., and other financial firms alleging that the defendants aided the fraud that led to Enron's collapse. The court granted defendants' motion to dismiss, holding that the plaintiffs lacked standing because they were only "participants" in, as opposed to owners of, the Enron debt securities at issue when the suit was filed.

In *In re Enron*, the plaintiffs asserted claims as successors in interest to claims of Prudential, which had purchased more than \$115 million in Enron debt securities (notes). Bear Stearns in turn purchased a "100 percent participation interest" in Prudential's rights associated with the notes. Bear Stearns did not own the notes nor did Bear Stearns have independent litigation rights related to such notes. The plaintiffs had secured a sub-participation interest in the notes through Bear Stearns. The plaintiffs claimed they had standing to bring claims related to the securities because their sub-participation agreement with Bear Stearns assigned them complete ownership of notes. The court, however, concluded that no interests had been "assigned" to plaintiffs at the time they filed suit and their participation interest did not provide legal standing.

The court noted that the distinction between an assignment and participation agreement—which plaintiffs misconstrued—was critical to resolving plaintiffs' standing. A plaintiff may obtain standing through an assignment because it is a complete transfer of existing rights and interests; thus, the assignee can bring an action in his own name. In a participation agreement, however, the participants lack standing because they have no independent litigation rights. Accordingly, the court dismissed plaintiffs' claims because they lacked standing.



Statute of Limitations

Applying Merck: Claims Under Section 10(b)

The statute of limitations for private securities fraud claims under Section 10(b) of the Exchange Act provides that cases must be brought within "two years after the discovery of the facts constituting the violation" or no later than five years after the violation. In 2010, the Supreme Court significantly curtailed the ability of defendants to assert the statute of limitations as a defense under Section 10(b). See *Merck & Co. v. Reynolds*, __ U.S. __, 130 S. Ct. 1784 (2010). In resolving a circuit split on how the discovery rule applies to Section 10(b) claims, the Court held in *Merck* that the limitations period begins to run when a plaintiff discovers or should have discovered with reasonable diligence the facts constituting the fraud, including facts showing scienter. The Court also held that the concept of "inquiry notice" could not be reconciled with Section 10(b), which makes actual "discovery" the triggering

event. Most importantly, the Court held that scienter-related facts (i.e., facts showing that an allegedly false or misleading statement was made knowingly or with reckless disregard for its truth) are among “the facts constituting the violation” that a plaintiff must have discovered in order for the limitations period to begin. The Court noted that often a materially false statement (such as an incorrect prediction of earnings) does not suggest scienter on its face and, thus, awareness of the untrue statement alone would not be enough.

Although *Merck* clarified certain aspects about the statute of limitations in private securities fraud suits, it left a number of issues unresolved—some of which were addressed in 2011.

For instance, the *Merck* Court held that scienter-related facts are among the facts constituting the violation, but it did not specify how *much* information an investor must have about scienter before “the facts constituting the violation” are deemed fully discovered. In vacating a dismissal of a complaint on limitations grounds in *City of Pontiac General Employees’ Retirement System v. MBIA, Inc.*, 637 F.3d 169 (2d Cir. 2011), the Second Circuit linked the standard for discovering facts for limitations purposes—including facts showing scienter—to the applicable pleading standard under Federal Rule of Civil Procedure 12(b)(6). Under the Second Circuit’s holding, an investor has not “discovered” scienter-related facts until it has enough information to adequately plead facts raising a “strong inference” of scienter. Under *City of Pontiac*, the ability of a defendant to successfully assert a statute of limitations defense at the dismissal stage becomes exceedingly difficult. For a court to dismiss a securities fraud claim on the basis of the statute of limitations under *City of Pontiac*, a defendant would need to demonstrate the existence of facts raising a “strong inference” of scienter—precisely the showing that will defeat that same defendant’s Rule 12(b)(6) pleading challenge to the plaintiff’s scienter allegations in the complaint. Therefore, in many instances, a defendant may be required to pick one line of attack over the other.

The ability of a defendant to successfully assert a statute of limitations defense at the dismissal stage becomes exceedingly difficult.

In 2011, the sole court applying *City of Pontiac* in dismissing a securities fraud claim on timeliness grounds did so under unusual circumstances. In *Stichting Pensioenfonds ABP v. Countrywide Fin. Corp.*,—F. Supp. 2d—, 2011 WL 3558173 (C.D. Cal. Aug. 9, 2011) a number of similar suits against the same defendants had been filed more than two years before the suit at issue was filed. Following *City of Pontiac*, the *Stichting* court held that the new fraud claims were time barred because some of the prior suits had survived motions to dismiss, demonstrating that the *Stichting* plaintiffs could have adequately pled scienter-related facts more than two years before filing their suit.

Another interesting 2011 decision time-barring a securities fraud claim is *Roaring Fork Capital SBIC, L.P. v. ATC Healthcare, Inc.*, 2011 WL 1258504 (D. Colo. Mar. 29, 2011). While *Merck* rejected the “inquiry notice” concept that certain “storm warnings” or other events suggestive of wrongdoing automatically begin the running of the limitations period, the Supreme Court did state that such an event could be relevant “to the extent [it] identif[ies] a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating.” In *Roaring Fork*, the district court held that the plaintiff was on inquiry notice when the company publicly reported certain unquantified irregularities in its financial reporting. The court held that, in the face of such a “storm warning,” a reasonable investor “would not simply have shrugged off this ambiguity and assumed the best; he or she would have sought further

detail from [the company] about the nature and amount of the particular items of concern.” The court further supposed that a “diligent investor could have then requested and obtained access to [the company’s] books within roughly 60 days” and thereby learned sufficient facts to support a claim. The court used that date—60 days after the defendant’s public disclosure of “accounting irregularities” as the beginning of the Section 10(b) limitations period. Thus, despite the fact that an investor could not have discovered the fraud more than two years before filing suit on the basis of publicly-available information, the court held that the fraud claim was time-barred. The dismissal in *Roaring Fork* has not been appealed. *Roaring Fork* demonstrates that storm warnings and other related events may remain relevant despite the *Merck* decision.

Roaring Fork demonstrates that storm warnings and other related events may remain relevant despite the *Merck* decision.

Merck left open what other facts related to the alleged fraud need to be found by a plaintiff before the violation is deemed “discovered.” In *McCann v. Hy-Vee*, —F.3d—, 2011 WL 5924414 (7th Cir. Nov. 22, 2011) (Posner, J.), the Seventh Circuit concluded that injury is not among the facts to be discovered before the limitations period begins to run. *McCann* first addressed the second prong of the timing requirement—providing that a securities fraud suit must be brought within “five years of the violation”—and held that this provision is a statute of repose (which unlike a statute of limitations is not subject to equitable tolling doctrines). The court further held that a “violation” does not include injury to the investor; thus a violation can occur (e.g., when the fraudulent statement is made) before the investor sells the security at issue (when the investor ultimately suffers an injury). Under *McCann*, the five-year period can cut off a securities fraud claim even before the investor has sold the relevant security. Although the first prong of the timing requirement—providing a securities fraud suit must be brought within “two years of the discovery of the facts constituting the violation”—was not directly at issue, the *McCann* court opined that “violation” has the same meaning. The *McCann* court expressed concern that a contrary ruling would allow an investor privately aware of a securities fraud violation to hold the security and sell at an opportunistic time many years in the future in order to maximize damages.

Tolling Issues in Section 11 and 12 Cases

Suits under Sections 11 and 12 of the Securities Act of 1933 are subject to a three-year statute of repose running from the date of the public offering for Section 11 claims and from the date of the sale to the plaintiff for Section 12 claims. Before 2011, few courts had decided whether *American Pipe* tolling—a class action doctrine that tolls the running of the limitations period for absent class members for claims that are asserted in a class action complaint—would allow plaintiffs to file suit for a Section 11 or 12 violation three years after the date triggering the running of the limitations period.

In the aftermath of the subprime credit crises, a number of class actions under Sections 11 and 12 were filed against banks and mortgage companies. As discussed above, many courts later dismissed claims related to mortgage-backed security offerings in which the named plaintiffs did not participate, on the basis of lack of standing. After these dismissals, investors who *did* purchase the securities sought to intervene or file a separate suit, in some instances more than three years after the offering and purchase of the security. The courts’ determination of whether the newly asserted claims of absent class members were time-barred or whether tolling permits them hinged on whether *American Pipe* is characterized as an equitable tolling doctrine (which cannot toll beyond a statute of repose period) or a legal tolling doctrine (which can). The five courts to decide the issue in 2011—all within the Southern

District of New York—have split. *Compare Int’l Fund Mgmt. S.A. v. Citigroup Inc.*,—F. Supp. 2d—, 2011 4529640 (S.D.N.Y. Sept. 30, 2011) (*American Pipe* tolling allows filing of § 11 and § 12 claims beyond the three-year repose limit); *In re Morgan Stanley Mortgage Pass-Through Certificates Litig.*,—F. Supp. 2d—, 2011 WL 4089580 (S.D.N.Y. Sept. 15, 2011) (same); with *In re IndyMac Mortgage-Backed Sec. Litig.*, 793 F. Supp. 2d 673 (S.D.N.Y. 2011) (*American Pipe* tolling does not permit filing of § 11 and § 12 claims beyond the three-year repose limit); *In re Lehman Bros. Sec. & ERISA Litig.*,—F. Supp. 2d—, 2011 WL 1453790 (S.D.N.Y. Apr. 13, 2011) (same); *Footbridge Ltd. Trust v. Countrywide Fin. Corp.*, 770 F. Supp. 2d 618 (S.D.N.Y. 2011) (same). All of these cases, except *International Fund Management*, followed the pattern described above in which Section 11 and 12 claims asserted in an earlier class action were dismissed for lack of standing. Thus, in the cases holding that *American Pipe* tolling is inapplicable to the statute of repose, the investors seeking to intervene or file a separate suit lost their claims, despite not knowing that the earlier class plaintiff lacked standing to protect their interests.

In a few cases where investors also asserted Section 11 and 12 claims that were *not* beyond the repose period, plaintiffs argued that absent class members can invoke *American Pipe* tolling to toll the one-year limitations period when these claims in the earlier class action were dismissed for lack of standing. The defendants argued that a class action complaint should not toll claims for which the court never had jurisdiction. The courts addressing this issue, however, held that a class action complaint tolls the statute of limitations for all claims asserted, even claims for which the court lacked jurisdiction. *In re Morgan Stanley*, 2011 WL 4089580, at *18; *In re IndyMac*, 793 F. Supp. 2d at 646-47; see also *In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326 (S.D.N.Y. 2011) (investor plaintiffs could invoke *American Pipe* tolling for claims in class action that were dismissed for lack of standing).

Now Pending in the Supreme Court: Limitations for Claims Under Section 16(b) of the Exchange Act

In November 2011, the Supreme Court heard oral argument on an appellate ruling that the statute of limitations for claims under Section 16(b) of the Securities Exchange Act, prohibiting short swing sales by corporate insiders, is tolled until the insider discloses the transactions in a statutorily required report. *Simmonds v. Credit Suisse Sec. (USA) LLC*, 638 F.3d 1072 (9th Cir. 2011). Section 16(b) provides that “no...suit shall be brought more than two years after the date such profit was realized” from the alleged transaction. The derivative plaintiffs seek to affirm the Ninth Circuit ruling, which permits tolling indefinitely until the insider discloses the transactions in a statutorily required § 16(a) report, even after the company actually discovers the prohibited transactions. The appellant-defendants argued that Section 16(b) operates like a statute of repose, preventing application of various tolling doctrines. The United States argued for a discovery approach, i.e., that the statute of limitations for a Section 16(b) claim begins to run when the company would have discovered the prohibited short swing sale.

The Supreme Court is currently considering whether the statute of limitations for claims under Section 16(b) of the Securities Exchange Act, prohibiting short swing sales by corporate insiders, is tolled until the insider discloses the transactions in a statutorily required report.



Claims Against Auditors

Federal courts decided several cases in 2011 involving allegations of securities violations against companies' outside auditors. As in past years, a primary focus of those decisions has centered on whether auditors intentionally or recklessly ignored "red flags" when conducting audits and certifying financial statements. The law remains unclear on exactly what counts as a red flag or what specific kinds of conduct courts will view as intentional or reckless. In light of this uncertainty, auditor defendants may continue to have success in some courts by arguing that an alleged red flag is not really a red flag or that the auditor was unaware of the red flag.

Cases Permitting Claims Against Auditors to Proceed

In *New Mexico State Investment Council v. Ernst & Young, LLP*, 641 F.3d 1089 (9th Cir. 2011), the Ninth Circuit reversed the dismissal of securities fraud claims against Ernst & Young. The plaintiffs alleged that Ernst & Young—as outside auditor for Broadcom Corp.—knew or was reckless in not knowing that its unqualified opinion of Broadcom's 2005 financial statements was false and misleading due to a stock option backdating scheme. The court analyzed whether the plaintiffs had sufficiently alleged scienter against Ernst & Young, and focused the inquiry on the so-called "red flag" doctrine, noting that "the more facts alleged that should cause a reasonable auditor to investigate further before making a representation, the more cogent and compelling a scienter inference becomes." The court found that the plaintiffs' complaint sufficiently alleged that Ernst & Young recklessly ignored red flags by allegedly (1) failing to investigate whether Broadcom had properly accounted for stock and instead accepting management's word without receiving documentation; (2) failing to audit options that had supposedly been granted on dates when Ernst & Young should have known that Broadcom's compensation committee was not legally constituted; and (3) participating in implementing corrective reforms to Broadcom's stock options accounting procedures without questioning whether the accounting that pre-dated the reforms was flawed.

Similarly, in *In re Bear Stearns Companies, Inc. Sec., Deriv., and ERISA Litig.*, 763 F. Supp. 2d 423 (S.D.N.Y. 2011), the court found that the plaintiffs' claims against Bear Stearns' outside auditor could survive a motion to dismiss. Deloitte had audited Bear Stearns' financial statements in the time period leading up to Bear Stearns' collapse. The court conducted a similar "red flags" analysis and found that the complaint adequately alleged that Deloitte knowingly or recklessly ignored numerous signs that should have led it to question whether Bear Stearns was engaged in wrongdoing. The alleged red flags included allegations that Deloitte ignored warning signs that Bear Stearns (1) used mortgage valuation models that the SEC had criticized as inaccurate; (2) had been warned by the SEC that its valuation models did not reflect key housing indicators; (3) received collateral from one of its hedge funds that was worth far less than the value of the loan that Bear Stearns made to the fund; (4) lacked adequate internal controls, and (5) failed to disclose weaknesses in financial models and risk management procedures.

Cases Dismissing Claims Against Auditors

In *Dronsejko v. Grant Thornton*, 632 F.3d 658 (10th Cir. 2011), the Tenth Circuit affirmed the district court's dismissal of the plaintiffs' securities fraud claims against Grant Thornton, the outside auditor for iMergent. The plaintiffs alleged that Grant Thornton either knew or was reckless in not knowing that iMergent's revenue recognition policy violated GAAP, yet certified iMergent's financial statements anyway. The case turned on whether certain receivables that had a 53 percent collection

rate could constitute “probable collectability” for accounting purposes. The plaintiffs contended that two accounting sources on GAAP interpretation should have led Grant Thornton to conclude that a 53 percent collection rate fell short of a probable collectability threshold. The court, however, found that both sources were general and ambiguous, and therefore did not fault Grant Thornton for how it applied GAAP. The sources were also “low on the hierarchy of sources used to interpret GAAP.” Grant Thornton could not have been reckless for failing to follow one particular interpretation of ambiguous sources. Absent sufficient allegations of recklessness, the plaintiffs could not adequately allege scienter and could not maintain a claim against Grant Thornton.

In *Stephenson v. PricewaterhouseCoopers, LLP*, 768 F. Supp. 2d 562 (S.D.N.Y. 2011), the court found that the plaintiff failed to adequately allege scienter against PricewaterhouseCoopers, the outside auditor of a Madoff feeder fund. While the plaintiff alleged that PricewaterhouseCoopers ignored multiple red flags about the operation of Bernard L. Madoff Investment Securities, LLC—its client’s general partner—that should have prompted closer scrutiny of the client’s financial statements, the court construed the “red flags” as allegations that PricewaterhouseCoopers merely had “access to information by which it *could* have discovered warning signs of fraud.” The plaintiff did not adequately plead that PricewaterhouseCoopers actually knew of the red flags, and an auditor cannot intentionally or recklessly disregard red flags of which it is unaware.

Similarly, the court dismissed securities fraud claims against Deloitte in *In re Franklin Bank Corp. Sec. Litig.*, 782 F. Supp. 2d 364 (S.D. Tex. 2011). Deloitte was the outside auditor for Franklin Bank. The bank faced difficulties during the financial crisis and was shut down in 2008 with the FDIC appointed as receiver. Franklin Bank subsequently restated its 2006 financial statements. Shareholder plaintiffs alleged that Deloitte knowingly or recklessly certified Franklin Bank’s financial statements and failed to comply with GAAP and GAAS in conducting its audit. The Court noted the high bar for pleading scienter against an auditor and found that the plaintiffs had not alleged any facts to establish that Deloitte acted knowingly or recklessly regarding its certification of Franklin Bank’s financial statements. The plaintiffs apparently did not allege that Deloitte ignored any red flags, and the court ultimately concluded that the plaintiffs’ allegations “reveal little more than their assertions that Deloitte’s statements were false when made because the bank later announced a need to restate certain financial information.”

XII Claims Against Rating Agencies

In 2011, federal courts addressed issues relating to credit rating agencies’ potential liability for investors’ losses in connection with mortgage-backed securities (“MBS”).

Are Rating Agencies “Underwriters” or “Control Persons”?

In *In re Lehman Brothers Mortgage-Backed Securities Litigation* (“*Lehman Brothers*”), the Second Circuit held that the rating agencies’ alleged conduct did not constitute that of “underwriters” or “control persons” under the Securities Act of 1933. *In re Lehman Brothers Mortgage-Backed Securities Litigation* (“*Lehman Brothers*”), Civil Action Nos. 10-0712-cv, 10-0898-cv, and 10-1288-cv (2nd Cir. May 11, 2011). The plaintiffs alleged that the rating agencies (1) actively aided in the structuring and securitization of MBS; (2) failed to update risk assessment models to reflect the presence of high-risk loans in MBS; and (3) reviewed draft prospectuses for MBS and provided comments to issuers. The plaintiffs alleged that this conduct led to misrepresentations and omissions in the MBS offering documents, particularly inaccurate credit ratings.

In rejecting the plaintiffs' assertion that rating agencies were "underwriters" of MBS, the Second Circuit noted that underwriters are those that participate in (1) purchasing securities from the issuer with a view toward distribution or (2) selling or offering securities on behalf of the issuer. The Court found it was not enough that rating agencies had allegedly engaged in an "iterative process" with issuers when constructing MBS, applied outdated risk assessment models to MBS, or reviewed offering documents and provided feedback to issuers.

Although the plaintiffs had adequately pleaded primary violations of Section 11 of the Securities Act by MBS issuers or depositors, the Second Circuit also rejected the plaintiffs' theory that rating agencies should be held liable for these violations as "control persons." The court held that the rating agencies' active collaboration, direct input, advisory opinions, and guidance related to the issuance of MBS were *not* sufficient to show control. Rather, the court concluded that control required a "showing of power to direct the primary violators' 'management and policies'" and that the plaintiffs had failed to make such a showing as to the rating agencies.

The Second Circuit held that the rating agencies' alleged conduct did not constitute that of "underwriters" or "control persons" under the Securities Act of 1933.

Federal Preemption and the First Amendment

In *Genesee County Employees' Retirement System v. Thornburg Mortgage Securities Trust 2006-3*, a federal district court in New Mexico addressed various defenses advanced by rating agencies facing potential liability under state statutory securities laws. *Genesee County Employees' Retirement System v. Thornburg Mortgage Securities Trust 2006-3* ("Genesee County"), Civil Action No. 1:09-cv-0300-JB-KBM (Jan. 12, 2011). The plaintiffs in that case alleged that the rating agencies violated the New Mexico Securities Act ("NMSA") by (1) using defective risk assessment models when assigning credit ratings; (2) failing to conduct reasonable due diligence into underwriters' representations regarding MBS; (3) lacking the resources to adequately and properly rate MBS; (4) issuing false and misleading ratings of the MBS in question; and (5) not being sufficiently independent when assigning ratings to MBS.

The court held that the plaintiffs' first three allegations were barred by the federal Credit Rating Agency Reform Act of 2006 ("CRARA"). According to the court, those allegations addressed the substance of credit ratings or the methodologies used to determine credit ratings, which are issues that CRARA prevents states from regulating. However, the court allowed the plaintiff's remaining allegations relating to fraud (a traditional state law issue) to proceed because there was no indication that CRARA was intended to supplant such causes of action.

The court also held that the credit ratings issued by the rating agencies were not protected by the First Amendment to the United States Constitution because the ratings were not widely disseminated to the public and did not relate to public figures such as public corporations. In addition, the court held that the free flow of information did not require protection of alleged false and misleading credit ratings. Ultimately, the court held that the plaintiffs' allegations were sufficient to state a cause of action under the NMSA against only one of the rating agencies.