

The Tactics of Asserting the Statute of Limitations Defense After *Merck v. Reynolds*

BY MIA MAZZA

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In *Merck & Co. v. Reynolds*,¹ the Supreme Court resolved a circuit split regarding the two-year statute of limitations under § 10(b) of the Securities Exchange Act of 1934. The statute² provides that a securities claim may be brought no later than two years after the “discovery of the facts constituting the violation” or five years after the violation, whichever is earlier. The defendants in *Merck* argued that the two-year provision does not require “discovery” of facts showing scienter—an intent to defraud investors. Rather, the defendants argued, “discovery” occurs “at the point where the [publicly available] facts would lead a reasonably diligent plaintiff to investigate further.”

The Court disagreed with the defendants’ reading, and held that “facts showing scienter are among those that ‘constitute the violation.’” “Accordingly, “the limitations period does not begin to run until... a reasonably diligent plaintiff would have

discovered ‘the facts constituting the violation,’ including scienter.”

The Supreme Court then applied this standard to the facts of *Merck*, finding that the defendant had not demonstrated the statute of limitations expired before the initial complaint was filed on November 6, 2003. The Court listed the relevant scienter-related facts, “as we have gleaned

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Securities Litigation Report

West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

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One Year Subscription ■ 10 Issues ■ \$666.90
(ISSN#: PENDING)

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From the EDITORS

Plaintiffs Taking It on the Chin So Far in Lawsuits Stemming from Financial Crisis

As the lingering financial impact of the worst U.S. economic crisis since the Great Depression begins to dissipate, plaintiffs and their lawyers are seeing their chances for success in bringing fraud claims against defendant financial institutions evaporate just as quickly.

Beginning in March, a flood of securities litigation lawsuits claiming fraud against various financial institutions for their actions during the subprime credit crisis and subsequent global economic meltdown have been dismissed in courts at a rate almost twice that of the historic average for securities litigation cases. According to numbers compiled by insurance industry blog *The D&O Diary*, two-thirds of securities fraud suits filed since the end of 2007 have been dismissed in the earliest stages of litigation, although in some cases the plaintiffs have been allowed to re-file with stronger allegations. The average dismissal rate for securities fraud cases is around 33%, according to *The D&O Diary*.

Interestingly, the defending banks benefiting from these dismissals—including Wall Street heavyweights like Morgan Stanley and Merrill Lynch—ironically seem to be enjoying the bitter fruits of the very economic catastrophe to which they arguably contributed. Indeed, defendants are racking up court dismissals by arguing that plaintiffs' losses were caused not by corporate fraud or omission, but by a massive global financial downturn that pummeled every financial institution on Wall Street and beyond.

Plaintiffs' attorneys complain that the suits are being dismissed so early in the litigation process that they don't have time to properly gather evidence or fully investigate the case. That problem for plaintiffs, of course, has less to do with the nature of the subprime crisis and more to do with the legacy of Private Securities Litigation Reform Act (PSLRA) and its prodigies of *Tellabs*,

Twombly and *Iqbal*. The PSLRA's effort to derail a "rush to the courthouse" has instead, plaintiffs attorneys say, left investors with the herculean task of essentially proving a case, pre-discovery, or face an early exit.

Plaintiffs' attorneys complain that the suits are being dismissed so early in the litigation process that they don't have time to properly gather evidence or fully investigate the case.

While the banks' 'global meltdown' argument is defensible in the sense that in a sea of sinking ships it may not be possible to find the single entity responsible for the holes in your own hull (or your own portfolio), the ability for an individual entity to escape liability because it had the good fortune to be committing the same reckless acts everyone else was can leave a sinking feeling, too.

Introducing New Editorial Board Member... I would like you to join all of us at *Securities Litigation Report* in welcoming Christian Siebott, of Bernstein Liebhard LLP, to our Editorial Advisory Board.

Christian focuses his practice in complex and class actions litigation, including securities, anti-trust, whistleblower, civil RICO, and landlord/tenant cases. He has worked on several noteworthy cases, including one of the largest securities class actions ever litigated (*In re Initial Public Offering Securities Litigation*). For *SLR*, Christian recently co-authored an article for the March issue examining the decision in *Ashcroft v. Iqbal* and its impact on class action securities litigation. In this issue, he has penned a piece on the Second Circuit's recent decision in *PIMCO Funds, et al v. Mayer Brown LLP, et al* that could greatly impact the aiding and abetting debate raging in Congress and elsewhere.

We at *SLR* are grateful to have Christian on board, and look forward to his insight and authorship in the future.

—JOSEPH M. MCLAUGHLIN & GREGG WIRTH

CONTINUED FROM PAGE 1

them from the briefs, the record, and the opinions below,” and divided them into those that were publicly available “pre-November 2001” and those that were not revealed until “*after* the critical date.” The Court discussed each of the “pre-November 2001 facts” and found that none of them, “whether viewed separately or together, reveal ‘facts’ indicating scienter.”

Even before *Merck*, the statute of limitations was a challenging defense for a securities defendant to win. Now, the defendant must demonstrate that facts “indicating” his own intent to defraud not only exist, but were available to the reasonably diligent public more than two years before the complaint was filed. This can be an awkward argument for someone whose ultimate job is to show that he never had *any* intent to defraud.

Although *Merck* may appear to put defendants in a double bind, reports of the statute’s death are greatly exaggerated. Three potential ramifications of *Merck* may emerge as late-filed actions continue to come under scrutiny.

A Renewed Interest in Rule 12(c)

Rule 12(c) of the Federal Rules of Civil Procedure states: “After the pleadings are closed—but early enough not to delay trial—a party may move for judgment on the pleadings.”³

The Rule 12(c) motion for judgment on the pleadings has not been, but may now become, a preferred vehicle for asserting the statute of limitations defense. As outlined below, we have now seen in *Merck* and companion case *Betz v. Trainor Wortham & Co.*⁴ (brought under Rule 12(b)(6) and Rule 56 respectively) some of the ways in which a statute of limitations defense can get caught in limbo or bogged down in what may be seen as factual disputes. Filing under Rule 12(c) may help minimize these problems.

Merck and Rule 12(b)(6)

Securities defendants traditionally respond to the filing of the complaint by filing a Rule 12(b)(6) motion to dismiss for failure to state a claim. One of the securities defendant’s primary objec-

tives is to emphasize the exacting scienter pleading requirements of the Private Securities Litigation Reform Act of 1995 (the “Reform Act”) and demonstrate that they have not been met.

Although parties are permitted to make “alternative” or “inconsistent” arguments under Rule 8(d)(3), there is nevertheless a real tension between arguing (i) that plaintiffs fall short of meeting the Reform Act’s stringent standard for pleading scienter, *and* (ii) that “‘facts’ indicating scienter” were available to the reasonably diligent public more than two years before the complaint was filed. Combining both arguments in one motion may serve to undermine one or both of these points.

That is the way the issue came up in *Merck*. There, the statute of limitations was asserted in the defendant’s Rule 12(b)(6) motion to dismiss, alongside Merck’s challenge to the sufficiency of the scienter allegations under the Reform Act. The district court ruled solely on the basis of the statute of limitations and did not reach Merck’s Reform Act arguments.

On appeal, the Third Circuit and the Supreme Court set forth a chronology of the “events” that allegedly revealed scienter-related facts. They then looked at the events that took place more than two years before the complaint was filed, considered them separately and together, and (in the case of the Supreme Court) determined that they did not reveal “‘facts’ indicating scienter.”

The Supreme Court decidedly did not identify which “events” in the chronology *did* reveal “‘facts’ indicating scienter.” Rather, the Court stated: “Regardless of which, *if any*, of the events following November 6, 2001, constituted ‘discovery,’ we need only conclude that prior to November 6, 2001, ...Merck has not shown that a reasonably diligent plaintiff would have discovered, ‘the facts constituting the violation.’” (*Emphasis added.*)

Merck had argued below, in the alternative, that the complaint failed to allege facts showing a strong inference of scienter. The district court did not rule on that issue. To credit Merck’s Reform Act challenge, the Supreme Court had to leave open the possibility that no “‘facts’ indicating scienter” existed at all. If the district court had found

that the complaint satisfied the Reform Act's scienter pleading requirements, the analysis—and the result—might have been different.

So long as a defendant is mounting a full frontal assault on the pleadings under the Reform Act, and wants the court to take that assault with the seriousness it deserves, he now risks getting caught in *Merck*-limbo if he simultaneously raises the statute of limitations defense. Before the court has identified a set of facts that collectively meets the Reform Act's requirements for pleading scienter, the question whether such a set of facts even exists remains open. With the court focusing intently on the Reform Act's stringent pleading requirements, there is a possibility the court will conflate that requirement with the *Merck* statute of limitations standard.

So long as a defendant is mounting a full frontal assault on the pleadings under the Reform Act, and wants the court to take that assault with the seriousness it deserves, he now risks getting caught in Merck-limbo if he simultaneously raises the statute of limitations defense.

It is all too easy for a court in that circumstance to isolate the scienter-related facts revealed before the two-year mark and declare that those facts did not “indicate scienter.” And at that point, the defendant's statute of limitations challenge is, for all practical purposes, finished.

The plaintiffs, however, are just getting started. Under the current practice of many courts, plaintiffs may be given multiple opportunities over multiple years to amend the complaint with additional allegations of scienter in an attempt to meet the Reform Act's heightened pleading requirements. If the plaintiffs eventually succeed in meeting the Reform Act scienter pleading standard, they will claim that the newly added facts could not have been discovered any earlier. A defendant wishing to revive his statute of limitations defense is, in many cases, looking at a summary judgment

motion, chock full of potential factual disputes that plaintiffs will claim only a jury can decide. That brings us to...

Betz and Rule 56

Before *Merck*, the common method for asserting the statute of limitations defense in a securities case was a Rule 56 summary judgment motion. As *Betz* illustrates, however, the question whether a reasonably diligent investor would have discovered certain “‘facts’ indicating scienter” earlier than the plaintiff did, is one that potentially could get stuck in a factual dispute that the plaintiffs will claim is unresolvable before trial.

In *Betz*,⁵ the Ninth Circuit overturned a district court ruling that would have granted summary judgment based on the statute of limitations defense. On May 3, the Supreme Court granted certiorari in *Betz* and remanded the case for further consideration in light of *Merck*.

The alleged facts of *Betz* are fairly straightforward. The plaintiff was told by the defendant brokerage firm in 1999 that if she invested her \$2.2 million with them, she could withdraw \$15,000 per month “without touching” the principal. The following events ensued:

- Beginning in 2000, the investor received 29 brokerage statements over a year-long period, each one reflecting a declining balance, until she finally received a statement in March 2001 showing a balance of \$848,000.
- In March 2001, one employee of the brokerage firm told her that “the shortfall was temporary, that the market would recover, and that in a year or less her account balance would be back to \$2.2 million.”
- Later in the spring of 2001, the brokerage firm employee who first set up her account told her that there was a “serious problem” with the way the portfolio had been managed, and that the president of the company would “take care of the account because it was the right thing to do.”
- In May 2002, the employee who set up the plaintiff's account told her that the president

“was meeting with other principals and attorneys” regarding her account, and that she “should be patient with them and not take any legal action.”

- In June 2002, the same employee called the plaintiff and advised her that the brokerage firm “was not going to do anything at all” to remedy the declining value of her account.

The plaintiff, after filing her complaint in July 2003, asserted that she did not realize she had been defrauded until she received the June 2002 phone call.

The Ninth Circuit reversed the district court’s grant of summary judgment, holding that a rational jury could conclude that a reasonable investor in the plaintiff’s shoes would have been lulled into complacency by the defendant’s assurances in response to the plaintiff’s inquiries, delaying the onset of legal action. The court held that, in light of that fact, the jury would need to decide when the statute of limitations began to run—it could not grant summary judgment.

What the Ninth Circuit did not do is analyze the above-listed facts to identify a specific point in time where “ ‘facts’ indicating scienter” emerged. The court may, however, now need to do that on remand.

Avoiding these Issues Under Rule 12(c)

An order denying a Rule 12(b)(6) Reform Act motion may provide a roadmap for asserting the statute of limitations defense under Rule 12(c). Under the *Tellabs* “collective facts” scienter standard (discussed below), the court likely will have included the plaintiffs’ entire litany of scienter-related facts, regardless of how “indicative” of scienter any particular fact was, in arriving at the conclusion that a “strong inference” of scienter had been pleaded.

The Reform Act’s “strong inference of scienter as to each defendant as to each statement” pleading standard is more demanding than *Merck*’s “ ‘facts’ indicating scienter” standard. A Rule 12(c) statute of limitations motion, therefore, could start with the scienter-related facts in the now-acceptable complaint and work backwards from

there, with the goal of identifying the point in time when the sum of scienter-related facts available to the reasonably diligent public *first* added up to “ ‘facts’ indicating scienter.”

As a motion based solely on the pleadings, a Rule 12(c) motion takes the plaintiff’s allegations as they have been set forth in the now operative complaint and assumes they are true. The whole point of that standard is to allow the litigants and the court to focus on the legal issues presented in the motion, without the distracting question of whether the jury has to be the one to decide what the facts are. The statute of limitations question could then be framed as one of pure law, involving whether a particular combination of publicly available facts “indicates” scienter. Rule 12(c) allows the parties to bolster their arguments with documents incorporated into the pleadings, and judicially noticeable facts, providing some opportunity to augment what is already in the complaint.

The Reform Act’s “strong inference of scienter as to each defendant as to each statement” pleading standard is more demanding than Merck’s “ ‘facts’ indicating scienter” standard.

The Rule 12(c) approach to statute of limitations requires there to be little or no factual dispute over what scienter-related facts were available to the reasonably diligent public at any given point in time. A defendant whose statute of limitations argument is based on “ ‘facts’ indicating scienter” that were available to the reasonably diligent public before the two-year mark, but were never alleged in any complaint and are not judicially noticeable, may be precluded from bringing that argument under Rule 12(c).

Turning *Tellabs* on Its Head

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,⁶ the Supreme Court held that a court evaluating whether a complaint satisfies the Reform Act

pleading requirements must “consider the complaint in its entirety,” inquiring “whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.”

Whereas *Tellabs* requires courts to take a holistic approach to scienter at the initial pleading stage, *Merck* will require courts to analyze scienter in a more surgical manner.

In assessing the statute of limitations under *Merck*, courts may be asked to take the “collective” body of facts and start slicing them away one by one, in reverse order according to when each fact became publicly available. As each fact is removed, it is examined to determine whether it was *the* very first fact that, upon emerging into the eye of the reasonably diligent public, “indicated” scienter.

In this process, the defendant’s job would be to establish that each fact revealed after the two-year mark was not a substantial indicator of scienter, and certainly not *the* fact before which there was no “indication” of scienter whatsoever.

An approach along these lines could avoid the *Merck* situation where everyone just turns to the facts available before the two-year mark and gives them a thumbs up or thumbs down. Once the pleadings are set and the court has found a “strong inference” of scienter, that means at some point before the complaint was filed there had to be at least one “‘fact’ indicating scienter” that became available to the reasonably diligent public.

If the plaintiffs and the court cannot say *when* the publicly available facts first indicated scienter, then they cannot say that the facts publicly available before the two-year mark did *not* indicate scienter. It could very well be that everything revealed after the pretwo-year mark—in the case of *Betz*, everything after the 29 statements showing a rapidly declining balance combined with the employee’s lame excuse therefore—was immaterial or cumulative. But that can only be determined if all of the scienter-related facts adding up to *Tellabs*-level scienter are taken into consideration, including those revealed within the two years preceding the complaint.

The plaintiffs’ job in this process would be to emphasize the utmost significance of each late revealed scienter-related fact as it is peeled away and examined. This could end up in them conceding that their first, second, and/or third complaints were filed without any indication of an intent to defraud.

Fewer Chances to Amend?

Consistent with the Reform Act and Rule 11, a plaintiff is prohibited from filing a federal securities fraud complaint if he is not aware of any facts indicating an intent to defraud.

The underlying purpose of the Supreme Court’s ruling in *Merck*, the Ninth Circuit’s in *Betz*, and Congress’s extension of the limitations period to two years in Sarbanes-Oxley was not to give plaintiffs more time to file more suits. It was to carry out the intended effect of the Reform Act—to prevent the filing of meritless strike suits—by allowing plaintiffs enough time to “find out more about exactly who participated in the fraudulent activity and how.”⁷ Congress found the previous one-year period was too short, driving plaintiffs “to race into court, so as not to be barred by time” and “throw[] in every possible defendant and every claim... almost immediately upon a change in the stock price.”⁸ The whole point of extending the period is to stop “encourag[ing] baseless or premature suits by requiring plaintiffs to sue before they can discover the facts underlying their claims.”⁹

But so long as courts grant securities plaintiffs multiple chances to amend their complaints in an effort to meet the Reform Act pleading requirements, the point of lengthening the statute of limitations is lost. There was no huge increase in the average length of time between stock drop and lawsuit after Sarbanes-Oxley raised the limitations period from one year to two.¹⁰ And absent a change in the courts’ approach to multiple amendments, *Merck*’s further expansion of the period likely will have the same effect, or lack thereof.

But so long as courts grant securities plaintiffs multiple chances to amend their complaints in an effort to meet the Reform Act pleading requirements, the point of lengthening the statute of limitations is lost.

Although Rule 15(a) requires that leave to amend a complaint shall be freely given “when justice so requires,” the Sixth and Third Circuits have held that the Reform Act limits those liberal amendment rules. For example, in *In re Champion Enter. Sec. Litig.*,¹¹ the Sixth Circuit noted that allowing plaintiffs to repeatedly amend their complaints frustrates the Reform Act’s purpose, which is to prevent “harassing strike suits filed the moment a company’s stock price falls.”¹²

The Reform Act’s legislative history supports the Sixth and Third Circuits’ position. The Senate stated that the Reform Act’s objectives are “[t]o provide a filter at the earliest stage (the pleading stage) to screen out lawsuits that have no factual basis,” “[t]o encourage attorneys to use greater care in drafting their complaints,” and “[t]o make it easier for innocent defendants to get cases against them dismissed early in the process.”¹³

The Ninth Circuit has held in the opposite direction—that “[a]dherence to [the policy of liberal leave to amend] is especially important in the context of the [Reform Act].”¹⁴ But this was before *Tellabs*, and before *Merck*, so it is possible we will see a shift in the Ninth Circuit’s view on allowing multiple amendments.

The practical effect of a liberal amendment policy is that there is no real disincentive for a plaintiff to continue filing as soon after the stock drop as possible, and *then* beginning to investigate whether there are any “facts’ indicating scienter” to be found. The overwhelming incentive of being in a good position to control the case early on remains in place, and compared to the significance of that, early dismissal is not much of a defeat when there will be years of chances to amend.

Reducing the number of times a court will grant leave to amend is only one way to give the lengthening of the statute of limitations its intended effect. The courts and Congress could:

- Require plaintiffs to file a noticed motion for leave to amend the complaint and attach the proposed amended complaint as an exhibit, rather than just asking for leave in a footnote at the end of the Rule 12(b)(6) opposition brief;
- Establish that the filing of a complaint that does not meet Reform Act pleading requirements does not stop the running of the statute of limitations (or at least the statute of repose); and/or
- Rule that the knee-jerk filing of a complaint that does not meet Reform Act pleading requirements will be a *negative* factor in the determination of Lead Plaintiff and Lead Counsel.

Any one of these steps could help bring *Merck*’s intended result into fruition.

NOTES

1. *Merck & Co., Inc. v. Reynolds*, Fed. Sec. L. Rep. (CCH) P 95733, 2010 WL 1655827 (U.S. 2010).
2. Securities Exchange Act of 1934, 28 U.S.C.A. § 1658(b)(1).
3. Fed. R. Civ. P. 12(c).
4. *Betz v. Trainer Wortham & Co., Inc.*, 519 F.3d 863, Fed. Sec. L. Rep. (CCH) P 94588 (9th Cir. 2008), cert. granted, judgment vacated, 2010 WL 1740527 (U.S. 2010).
5. *Betz*, 519 F.3d 863.
6. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S. Ct. 2499, 168 L. Ed. 2d 179, Fed. Sec. L. Rep. (CCH) P 94335 (2007).
7. S. Rep. No. 146, 107th Cong. 2d Sess. 9 (2002).
8. S. Rep. No. 146, 107th Cong. 2d Sess. 9 (2002).
9. *Betz v. Trainer Wortham & Co., Inc.*, 504 F.3d 1017, 1024, Fed. Sec. L. Rep. (CCH) P 94432 (9th Cir. 2007), opinion superseded on denial of reh’g, 519 F.3d 863, Fed. Sec. L. Rep. (CCH) P 94588 (9th Cir. 2008), cert. granted, judgment vacated, 2010 WL 1740527 (U.S. 2010).
10. See Cornerstone Research, *Securities Class Action Filings 2009: A Year in Review*, at pp. 6–7 (2010).
11. *Miller v. Champion Enterprises Inc.*, 346 F.3d 660, 690, 56 Fed. R. Serv. 3d 1177, 2003 FED App. 0359P (6th Cir. 2003).

12. See also *In re NAHC, Inc. Securities Litigation*, 306 F.3d 1314, 1332, Fed. Sec. L. Rep. (CCH) P 91988 (3d Cir. 2002); *California Public Employees' Retirement System v. Chubb Corp.*, 394 F.3d 126, 164, Fed. Sec. L. Rep. (CCH) P 93053 (3d Cir. 2004); *In re Zumiez Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) P 95104, 2009 WL 901934 (W.D. Wash. 2009).
13. 141 Cong. Rec. S 19146, at 19152 (daily ed. Dec. 22, 1995) ("Selected Bill Provisions of the Conference Report to H.R. 1058/S. 240," submitted by Rep. Bradley).
14. *Eminence Capital, LLC v. Aspeon, Inc.*, 316 F.3d 1048, 1052, Fed. Sec. L. Rep. (CCH) P 92257, 54 Fed. R. Serv. 3d 1141 (9th Cir. 2003); see also *Carol Gamble Trust 86 v. E-Rex, Inc.*, 84 Fed. Appx. 975, 979, Fed. Sec. L. Rep. (CCH) P 92698 (9th Cir. 2004).

Justice Scalia's Concurrence to *Merck*: Is Adopting the Ordinary Reader's Perspective a Solution to Judicial Activism?

BY BRIAN LEHMAN

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Attorneys, and perhaps the public, are often in the habit of concluding that personal and political considerations determine judges' decisions. Yet on this point, Justice Antonin Scalia's recent concurrence in *Merck & Co. v. Reynolds* should give us all pause.

Of course, Justice Scalia has not always been seen as a paragon of fairness and neutrality—as the following anecdote demonstrates: Four years

ago, during an oral argument before the Supreme Court, Scalia jokingly proposed a harsh interpretation of a securities law, one that would disadvantage plaintiffs. The lawyer at the podium breached decorum by replying, "Is that because you never met a plaintiff you really liked?"

That lawyer was Arthur Miller, co-author of the definitive treatise on federal civil procedure nicknamed "Wright & Miller."¹ Last month, lawyers reminded Miller of that exchange when New York University honored him, before an audience that prominently included Justice Ruth Bader Ginsburg, for his outstanding career.

Miller's story provides a good laugh—perhaps because while only a person of Miller's stature could get away with such a statement before the Justices, many of us secretly agree: Isn't it obvious that judges often let their policy preferences drive their interpretations of the law? Granted, Chief Justice John Roberts said during his confirmation hearing, "I will remember that it's my job to call balls and strikes, and not to pitch or bat." But a recent op-ed in *The New York Times* was persuasive in concluding that when it comes to judging on the High Court, "the umpire analogy is absurd."²

Still, Justices can sometimes surprise us by arguing or voting directly against what we thought were their ideological preferences—which brings us to *Merck*, and Justice Scalia's concurrence there.

In *Merck*, a statute required a plaintiff to bring a claim for securities fraud "2 years after the discovery of the facts constituting the violation" or "5 years after such violation," whichever occurred first. The Court, in an opinion written by Justice Stephen Breyer, held that the "word 'discovery' refers not only to a plaintiff's actual discovery of certain facts, but also to the facts that a reasonably diligent plaintiff would have discovered."

The *Merck* opinion has been seen as "pro-plaintiff"—unexpectedly so. The *Wall Street Journal* entitled a related blog post "Supreme Court Gives Unanimous (!) Go-Ahead to *Vioxx* Class Action." The blog post began by noting, "The current U.S. Supreme Court isn't one you necessarily think of as being friendly to shareholder class-action lawsuits."³ Also taken by surprise

was liability-insurance specialist Kevin LaCroix, who concluded on his blog, *The D&O Diary*, “I thought this case would likely lead to a victory for Merck in another defense friendly decision. Instead, the plaintiffs prevailed in a unanimous holding. Maybe my presumptions were completely off base, but I still find the outcome interesting and a little unexpected.”⁴

The decision itself may have been surprising, but what was actually shocking to many is that Justice Scalia would have gone further in favor of the plaintiffs than the majority did. In a concurrence joined by Justice Clarence Thomas, Justice Scalia argued that “discovery” means actual discovery, no more and no less. On his interpretation, a plaintiff who failed, or even refused, to investigate whether a violation had occurred would still have had two years from the point of his, her, or its actual knowledge of the violation to file an action (with the important caveat that—based on the second statutory limitation—the filing still could not occur more than “5 years after such violation”).

The [Merck] decision itself may have been surprising, but what was actually shocking to many is that Justice Scalia would have gone further in favor of the plaintiffs than the majority did.

Why did Justice Scalia reach such a pro-plaintiff conclusion? In part, it is because Justice Scalia attempts to be principled and to reach decisions impartially, regardless of the identity of the parties before him. While this is not an earth-shattering insight, it is one worth remembering in an era where some believe that judges are entirely results-oriented.

In part, too, Justice Scalia may also have been influenced by his method of interpretation. In *Merck*, he started by asking how an ordinary reader would interpret the term “discovery.” “In ordinary usage, ‘discovery’ occurs when one actually learns something new,” he wrote—before also referring to *Webster’s New International*

Dictionary. Later in his concurrence, Scalia noted that interpreting the term “discovery” to mean “actual discovery” was “the more natural reading.”

Scalia’s *Merck* concurrence thus indicates that changing one’s reference point to that of an ordinary reader may help temper even strong contrary policy preferences. Significantly, that same hypothesis has recently received some empirical support from a trio of scholars: Ward Farnsworth, Dustin Guzior, and Anup Malani. In their study,⁵ they found that if law students were asked whether a statute was ambiguous, the students would give answers that were biased by their own policy preferences. Moreover, this was true even when the study specifically told the students to put aside their own policy preferences and to determine which reading was most consistent with the ordinary meaning of the text.

Asking the study’s participants, however, whether the text would likely be read the same way by ordinary readers of English did not produce the same results. As Prof. Malani has explained, instead of asking students, “what they thought the statute meant as a matter of ordinary English, we asked them what they thought ordinary readers would think it meant. The answers were then remarkably different. They weren’t biased.”⁶

Future research may also support the hypothesis that asking how an ordinary reader would interpret a statute helps reduce a judge’s bias when interpreting a statute. If it does, then one of the most important questions to ask any person nominated to be a judge could be: “Do you agree to interpret a statute by at least considering what would an ordinary reader would think it meant?”

Notably, Senators of all political persuasions ought to be able to agree on the importance of this question—for while an “ordinary reader” approach elicited markedly “liberal” votes from Justices Scalia and Thomas in *Merck*, it should be just as likely to elicit “conservative” votes from more liberal justices in the future. Indeed, it is this approach’s very ability to transcend any personal ideology that proves its merit, and ought to allow it to draw bipartisan support.

NOTES

1. Wright, Charles A. & Miller, Arthur R., et al., Federal Practice & Procedure, St. Paul: Thomson West Publishing. © 1978-updates to 2010.
2. Geoffrey R. Stone, April 13, N.Y. Times, at A27, *Our Fill-in-the-Blank Constitution*.
3. See <http://blogs.wsj.com/law/2010/04/27/supreme-court-gives-unanimous-go-ahead-to-vioxx-class-action>.
4. See <http://www.dandodiary.com/2010/04/articles/securities-litigation/us-supreme-court-allows-merck-vioxx-securities-suit-to-proceed>.
5. Farnsworth, Ward, Guzior, Dustin F. and Malani, Anup, *Ambiguity About Ambiguity: An Empirical Inquiry into Legal Interpretation* (October 22, 2009). The Journal of Legal Analysis (Forthcoming) U of Chicago, Public Law Working Paper No. 280; Boston Univ. School of Law Working Paper No. 09-50.
6. See also <http://uchicagolaw.typepad.com/faculty/2010/04/ambiguity-in-legal-i.html>.

Piggybacking Through the Pleading Standards: Reliance on Third-Party Investigative Materials to Satisfy Particularity Requirements in Securities Class Actions

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After the tremors of the global financial crisis, many securities litigation practitioners anticipated a tsunami of actions by both government regulators and private litigants. The wave never arrived. To be sure, the collapse of institutions like Lehman Brothers and the revelations of several massive Ponzi schemes led to the filing of securities fraud class actions and government enforcement actions. But beyond these few high-profile cases, the volume of litigation has fallen short of expectations.

Recent signs from the Obama administration, including the Securities and Exchange Commission's (SEC) new action against Goldman Sachs, suggest that the long-awaited swell of enforcement actions by the SEC may finally be approach-

ing. However, it remains to be seen whether private litigation under § 10(b) of the Securities Exchange Act of 1934 will increase dramatically. On one hand, a dramatic increase seems unlikely given that securities class action plaintiffs must overcome the substantial pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act of 1995 (PSLRA) to even proceed to discovery.

On the other hand, as information is disclosed in federal enforcement actions, bankruptcy examiners' reports, or other public sources, plaintiffs seek to "piggyback" on those sources to plead sufficient particular facts to survive motions to dismiss. In some cases, plaintiffs have successfully predicated allegations on facts disclosed in available investigatory reports, as opposed to relying solely on a registrant's public disclosures and confidential witness statements, to plead facts sufficient to survive the inevitable motion to dismiss. However, reliance on the work of third-party investigators or litigants is not always permissible, and in some circumstances may even amount to dereliction of attorneys' Rule 11 obligations.

Pleading Standards in Rule 10(b) Cases

Observers who forecasted a surge in federal private securities litigation may have underestimated the barriers presented by the PSLRA, which stays all discovery during the pendency of a motion to dismiss.¹ The discovery stay, combined with the heightened standards for particularity applicable to fraud cases and securities fraud in particular, makes it difficult for plaintiffs who lack actual knowledge of a fraud and who are without access to internal company documents to sufficiently plead their claims under § 10(b).

As outlined in the 2005 Supreme Court decision in *Dura Pharmaceuticals v. Broudo*, a private cause of action for securities fraud under § 10(b) and Rule 10b-5 requires the following elements: (1) a material misrepresentation (or omission); (2) scienter, *i.e.*, "a wrongful state of mind"; (3) a connection with the purchase or sale of a security; (4) reliance (which is typically presumed in

cases relating to publicly-traded securities in presumptively efficient markets); (5) economic loss; and (6) loss causation, *i.e.*, "a causal connection between the material misrepresentation and the loss."²

Rule 9(b) of the Federal Rules of Civil Procedure and the PSLRA impose high standards for pleading at least the first two elements. A plaintiff must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading," and state with particularity facts supporting allegations made "on information and belief."³ This provision is sometimes described as a requirement that plaintiffs plead "falsity" with particularity and is consistent with Rule 9(b)'s requirement that "[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake." Additionally, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," *i.e.*, scienter.⁴ Scienter refers to "a mental state embracing intent to deceive, manipulate, or defraud."⁵

The application of these pleading standards has a great impact on the outcome of securities fraud cases and has been the subject of extensive appellate review. Recently, in *Merck & Co., Inc. v. Reynolds*, the Supreme Court held that the:

'fact' of scienter 'constitut[es]' an important and necessary element of a §10(b) 'violation.' A plaintiff cannot recover without proving that a defendant made a material misstatement with an intent to deceive—not merely innocently or negligently.⁶

In 2007's *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Court held that courts must consider "whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard."⁷ Plaintiffs frequently rely on *Tellabs* in urging a holistic construction of their allegations, and they argue that their averments collectively support an inference of scienter. However, *Tellabs* also directed courts to consider plausible opposing inferences.

In comparing the inferences that may be drawn from the facts alleged, “a court must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.”⁸ Because actions under § 10(b) and Rule 10b-5 require intentional deception, “non-culpable explanations” may include inferences of simple or even gross negligence.⁹

Additionally, in *Dura*, the Supreme Court held that a complaint must plead facts supporting the elements of economic loss and loss causation. The Court held insufficient a complaint alleging only that the plaintiffs had purchased publicly-traded stock at “inflated prices.”¹⁰ Justice Stephen Breyer’s opinion noted that the plaintiffs “fail[ed] to claim that Dura’s share price fell significantly after the truth became known... .” The *Dura* opinion has led federal courts to require allegations of a “corrective disclosure,” *i.e.*, a revelation to the investing public of the facts allegedly misrepresented or concealed and resultant decline in the stock price, to sufficiently plead economic loss and loss causation.¹¹ The corrective disclosure requirement is conceptually consistent with the PSLRA’s limit on damages, which is the difference between the purchase price “and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.”¹²

Traditional Sources of Information for Securities Fraud Allegations

The requirements that securities plaintiffs must satisfy are daunting and are intended to protect public registrants from the expense of litigating spurious or frivolous lawsuits (or paying costly settlements to *avoid* the expense of litigating spurious or frivolous lawsuits). Some members of the plaintiffs’ bar complain that it is now more difficult to plead a securities fraud case than it is to prove one at trial. Defense attorneys predictably have a different view of the pleading standards and the discovery stay, believing that their impact on meritorious lawsuits is low and is far exceeded by their effect in deterring and extin-

guishing strike suits. In any event, the challenge for plaintiffs lies largely in obtaining access to information. Even where a company discloses a prior misstatement or announces a restatement of its financial statements, plaintiffs complain of a lack of transparency. The specific circumstances that led to a prior misstatement (and the individuals responsible) are not always revealed to the public. Yet without those kinds of facts, plaintiffs are unlikely to construct § 10(b) claims that will survive a motion to dismiss.

The ability to plead particular facts relating to falsity and scienter is limited for plaintiffs who have no access to internal documents or witnesses. In one sense, the Supreme Court’s decision in *Merck* arguably helps plaintiffs in this regard by giving them more time to collect the facts giving rise to their claim. The Court held that a plaintiff does not “discover” his or her claim, and thereby commence the two-year limitations period, until the plaintiff knows or should know the facts related to defendants’ scienter.¹³ In another sense, however, the decision does not provide plaintiffs with any additional access to non-public facts that would potentially assist them in constructing their complaint, nor does it save them from the five-year statute of repose.¹⁴

Experienced plaintiffs’ counsel typically incorporate as much detail and reference to particular facts as possible into their complaints. As such, most complaints are replete with references to, and quotations from, a company’s public filings and disclosures. However, volume is not a proxy for particularity. Numerous appellate courts have affirmed dismissals of lengthy complaints with extensive references to public filings where plaintiffs have failed to plead sufficient facts relating to falsity or scienter.¹⁵

Many complaints bringing § 10(b) claims rely heavily on statements from confidential witnesses (CWs). To obtain such statements, plaintiffs’ law firms employ private investigators to contact individuals who may be able to provide relevant facts. These individuals might include former employees of the company whose disclosures are at issue. Employees of the company’s accountants or consultants may also be contacted. In recent years, plaintiffs’ investigators have even begun

to use online social media sites like LinkedIn or Facebook to locate former employees of companies they are investigating. Yet the use of CWs can be problematic, both practically and legally. Few individuals who know the facts relating to alleged securities fraud are inclined to cooperate with plaintiffs' attorneys. Moreover, prospective CWs may be limited by confidentiality agreements or, in the case of accountants, professional obligations. Courts are understandably skeptical of statements attributed by plaintiffs to CWs. In the wake of *Tellabs*, some appellate courts have held that allegations based on CWs must be discounted or disregarded.¹⁶ Other courts impose challenging requirements for consideration of CW-based allegations under the PSLRA. The Ninth Circuit, for example, imposes a two-part test to satisfy the PSLRA pleading requirements. First, CWs whose statements are introduced to establish scienter "must be described with sufficient particularity to establish their reliability and personal knowledge," and second, statements reported by CWs "must themselves be indicative of scienter."¹⁷ Plaintiffs rarely have access to witnesses who can satisfy those requirements. Regardless of whether a complaint reports damning statements from CWs, the failure to plead corroborating facts or to allege sufficient foundation for those CWs may result in dismissal.¹⁸

Piggybacking Allegations on Third-Party Reports

In light of the constraints of the PSLRA and their limited access to information, § 10(b) plaintiffs seek to benefit from the work product of parties who are not similarly constrained, such as regulators or bankruptcy examiners. Reports and complaints prepared by these third parties typically provide putative plaintiffs insider information to which they would not have otherwise had access, and which may sufficiently augment their allegations to survive dismissal at the pleading stage.

One source of material for securities plaintiffs is in the investigative reports of bankruptcy examiners. The Bankruptcy Code authorizes the appointment of examiners in certain Chapter 11 cases. The role of the examiner is "to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor..."¹⁹ Whereas plaintiffs' attorneys have no right to conduct prelitigation discovery, bankruptcy examiners avail themselves of Rule 2004 of the Federal Rules of Bankruptcy Procedure, under which they may compel the production of documents and the attendance of witnesses.²⁰ Not all bankruptcy examiners' reports are made public.²¹ However, those that are revealed to the public provide substantially more information than most plaintiffs' attorneys could expect in reaching out to possible confidential witnesses.

As a result, several recent high-profile cases have relied upon information revealed in bankruptcy examiners' reports. For example, a newly amended complaint in the Lehman Brothers securities litigation adds many references to the work of the examiner in the investment bank's bankruptcy. The complaint, which refers to the examiner's written report and to his testimony in Congress, alleges that senior officers at the bank knew of the "Repo 105" and "Repo 108" transactions that plaintiffs tie to the bank's eventual collapse. The complaint's allegations are based on communications between Lehman Brothers executives and the bankruptcy examiner during the investigation. It also includes allegations such as references to meetings between Lehman Brothers and its auditors, and it alleges the contents of notes prepared contemporaneously with those meetings.²² It remains to be seen whether the Lehman Brothers complaint will survive dismissal, but it is nevertheless striking how much more information is available to the plaintiffs in that case than in otherwise similar circumstances.

In other cases, plaintiffs that have relied on allegations in bankruptcy examiners' reports have defeated motions to dismiss. In the April 2007 bankruptcy of major subprime lender New Century Financial Corp., for example, the examiner issued a report that criticized New Century's former management and its outside auditor.²³ In subsequent securities litigation, the plaintiffs relied heavily on the examiner's report, even though it contained extensive information that plaintiffs could not corroborate through their own investigation. For example, the *New Century* complaint alleges that individual officers knew about problems in the company's loan portfolio. With respect to the auditor, the complaint identified particular documents received and analyses conducted by the audit firm, and even alleged facts relating to internal disagreements among specific audit team members. Even though the examiners' report arguably lacked reliable foundation and was designed to conjure claims on behalf of the bankruptcy estate, the district court denied the motions to dismiss filed by both the officer defendants and the auditors. In *In re Enron Securities, Derivative, and "ERISA" Litigation*, the plaintiffs also relied heavily on the findings of the bankruptcy examiner.²⁴ The court noted that:

[a]n examiner's investigative authority under Fed. R. Bankr. P. 2004 is broader than the scope of civil discovery. The investigation of an examiner in bankruptcy, unlike civil discovery under Rule 26(c), is supposed to be a "fishing expedition," as exploratory and groping as appears proper to the Examiner.²⁵

The court seemingly took no issue with the examiner's partisan role, however, and denied the defendants' motions to dismiss. Most recently, in *In re Semigroup Energy Partners, L.P.*, the district court denied several defendants' motions to dismiss a complaint that drew heavily from a bankruptcy examiners' report.²⁶

Reliance on information from examiners' reports is not without its drawbacks. For starters,

the fact that a company is in bankruptcy creates challenges for plaintiffs suing corporations and their officers. Plaintiffs may have to bring their claim in the bankruptcy court, and there may be limited assets available for settlement or recovery (although these challenges may not always be applicable in suits against officers or third parties such as accountants or consultants). Additionally, although a third-party report may reveal salacious, previously nonpublic facts, those facts may do nothing for plaintiffs' § 10(b) claims if they are not consistent with plaintiffs' theory of loss causation under *Dura*. For example, if an examiner's report reveals a scheme of fraudulent conduct or misstatements that were never revealed to the investing public, such revelations do little to support a plaintiff's claim. Plaintiffs must plead facts indicating economic loss following corrective disclosure of fraudulent misrepresentations. Courts have generally dismissed allegations of fraudulent statements where the "truth" behind those statements was never fully revealed to the market or cannot be tied to a drop in stock price.²⁷

Additionally, critics note that bankruptcy examiners are not neutral parties. Instead, they are driven by an agenda of marshalling all claims that a bankruptcy estate may have against, inter alia, former management, consultants, auditors, and so on. There is at least a genuine question whether attorneys can satisfy their Rule 11 obligations where their allegations are based not on their own investigation and clients' knowledge, but on the work product of a decidedly non-neutral third party. One court granted in part a motion to strike portions of a complaint where the complaint failed to make clear whether allegations made "on information and belief" were based solely on an examiner's report, or on separate investigation.²⁸ However, because of the extensive record available to examiners by virtue of Rule 2004, courts are generally inclined to allow plaintiffs to refer to bankruptcy examiners' reports.

Defendants have had more success precluding plaintiffs from piggybacking on another kind of third-party work product—complaints filed by

the SEC. Several courts have rejected complaints relying upon allegations drawn from SEC complaints.²⁹ In *In re Connetics Corp. Sec. Litig.*, for example, the court held that plaintiffs' counsel had a nondelegable duty under Rule 11(b) to "validate the truth and legal reasonableness of the papers filed... ." ³⁰ The court noted that the plaintiffs relied entirely on the allegations of a prior SEC complaint for several paragraphs and that they did "not contend that they conducted independent investigation into the facts alleged in the SEC complaint or had any additional bases for the specific allegations... ." In another case, in which plaintiffs referred to an SEC complaint for numerous fact allegations in the complaint, the court reached the same result, holding "Plaintiffs' attorneys cannot shirk their Rule 11 obligation to conduct an appropriate investigation into the facts that is reasonable under the circumstances by merely stating that 'the SEC alleges' certain additional facts."³¹

As a practical matter, the distinction between SEC allegations and bankruptcy examiner conclusions is not clear. The SEC frequently gains access to nonpublic information, either through cooperation or through administrative subpoenas before the filing of a complaint. The SEC presumably makes allegations in its complaints after investigation and with the same degree of good faith that examiners use in signing their reports. In reality, neither the SEC nor bankruptcy examiners can be considered "neutral." However, the court in *New Century* concluded that the bankruptcy examiner's report was more "reliable" than allegations in SEC complaints, and therefore refused to strike the complaint's allegations.

An Uncertain Future

The early stages of litigation under § 10(b) and Rule 10b-5 are, in large part, a battle for information. Plaintiffs often lack sufficient particular facts to surmount the high hurdles of the federal pleading standards. Public disclosures, investigation, and statements from confidential witnesses do not always provide sufficient facts to survive

a motion to dismiss. As discussed above, in some cases, plaintiffs may be able to piggyback upon the work of others with more access to information, such as bankruptcy examiners or other independent third parties. However, it is clear that attorneys cannot abrogate their Rule 11 obligations to independently investigate and verify the allegations in their complaints.

As such, the viability of a piggybacking strategy is often uncertain, and depends in large part on courts' assessments of the reliability of the piggybacked information.

NOTES

1. The Private Securities Litigation Reform Act of 1995 (PSLRA), 15 U.S.C.A. § 78u-4(b)(3)(B).
2. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341, 125 S. Ct. 1627, 161 L. Ed. 2d 577, Blue Sky L. Rep. (CCH) P 74529, Fed. Sec. L. Rep. (CCH) P 93218 (2005).
3. PSLRA, 15 U.S.C.A. § 78u-4(b)(1).
4. PSLRA, 15 U.S.C.A. § 78u-4(b)(2).
5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12, 96 S. Ct. 1375, 47 L. Ed. 2d 668, Fed. Sec. L. Rep. (CCH) P 95479 (1976).
6. *Merck & Co., Inc. v. Reynolds*, Fed. Sec. L. Rep. (CCH) P 95733, 2010 WL 1655827, *12 (U.S. 2010) (emphasis in original).
7. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 323, 127 S. Ct. 2499, 168 L. Ed. 2d 179, Fed. Sec. L. Rep. (CCH) P 94335 (2007).
8. *Tellabs*, 551 U.S. at 323.
9. See, e.g., *In re Imergent Securities Litigation*, 2009 WL 3731965, *7 (D. Utah 2009); *Frank v. Dana Corp.*, 649 F. Supp. 2d 729, 745, Fed. Sec. L. Rep. (CCH) P 95341 (N.D. Ohio 2009).
10. *Dura Pharm.*, 544 U.S. at 347.
11. See, e.g., *Teachers' Retirement System Of LA v. Hunter*, 477 F.3d 162, Fed. Sec. L. Rep. (CCH) P 94158 (4th Cir. 2007); *McKowan Lowe & Co., Ltd. v. Jasmine, Ltd.*, 231 Fed. Appx. 216, Fed. Sec. L. Rep. (CCH) P 94480 (3d Cir. 2007).
12. PSLRA, 15 U.S.C.A. § 78u-4(e)(1).
13. *Merck*, 2010 WL 1655827, *15.
14. 28 U.S.C.A. § 1658(b) ("[A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws... may be brought not later than... 5 years after such violation.").
15. See, e.g., *In re UTStarcom, Inc. Securities Litigation*, 617 F. Supp. 2d 964, 970 (N.D. Cal. 2009)(quoting *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1070 (9th Cir. 2008)) ("A litany of alleged false statements,

- unaccompanied by the pleading of specific facts indicating why those statements were false, does not meet this standard.”).
16. *Indiana Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc.*, 537 F.3d 527, 535, Fed. Sec. L. Rep. (CCH) P 94790 (5th Cir. 2008)(“Following *Tellabs*, courts must discount allegations from confidential sources.”); see also *Higginbotham v. Baxter Intern., Inc.*, 495 F.3d 753, 756-757, Fed. Sec. L. Rep. (CCH) P 94479 (7th Cir. 2007) (After *Tellabs* courts are required to “discount allegations that the complaint attributes to... confidential witnesses” because “it is hard to see how information from anonymous sources could be deemed ‘compelling’ or how we could take account of plausible opposing inferences.”).
 17. *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 995, Fed. Sec. L. Rep. (CCH) P 95038 (9th Cir. 2009), as amended, (Feb. 10, 2009)
 18. See, e.g., *Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 594 F.3d 783, 794, Fed. Sec. L. Rep. (CCH) P 95576 (11th Cir. 2010)(affirming dismissal despite “litany of confidential witnesses”); *Karpov v. Insight Ents.*, No. CV 09-856-PHX-SRB, Doc. 113, at 13-15 (D. Ariz. Apr. 30, 2010) (dismissal despite reference to 22 CWs where complaint “does not set forth the basis for the CWs’ firsthand knowledge of the state of mind of the... Defendants.”).
 19. The Bankruptcy Code, 11 U.S.C.A. 1104(c).
 20. Fed. R. Bankr. Proc. 2004; see also Fed. R. Bankr. Proc. 9016 (incorporating Fed. R. Civ. P. 45 for subpoenas in bankruptcy proceedings).
 21. See, e.g., *In re Ionosphere Clubs, Inc.*, 156 B.R. 414 (S.D. N.Y. 1993), judgment aff’d, 17 F.3d 600 (2d Cir. 1994)(denying motion to unseal examiner’s report).
 22. *In re: Lehman Brothers Securities and “ERISA” Litigation*, Case No. 09 MD 2017 (S.D.N.Y., filed Apr. 23, 2010).
 23. *In re New Century*, 588 F. Supp. 2d 1206 (C.D. Cal. 2008).
 24. *In re Enron Corp. Securities, Derivative & “Erisa” Litigation*, 2005 WL 3504860, *10 (S.D. Tex. 2005).
 25. *Enron*, 2005 WL 3504860 at *10 (quoting *Ionosphere Clubs*, 156 B.R. at 432).
 26. *In re Semigroup Energy Partners, L.P.*, Fed. Sec. L. Rep. (CCH) P 95734, 2010 WL 1816434, *9 (N.D. Okla. 2010).
 27. *Indiana State Dist. Council of Laborers and Hod Carriers Pension and Welfare Fund v. Omnicare, Inc.*, 583 F.3d 935, 944, Fed. Sec. L. Rep. (CCH) P 95384 (6th Cir. 2009), petition for cert. filed (U.S. May 14, 2010)(“a plaintiff must show that an economic loss occurred after the truth behind the misrepresentation or omission became known to the market.”).
 28. *In re Spiegel, Inc. Securities Litigation*, 382 F. Supp. 2d 989, 1013-1014, Fed. Sec. L. Rep. (CCH) P 92860 (N.D. Ill. 2004).
 29. See, e.g., *In re Connetics Corp. Securities Litigation*, 542 F. Supp. 2d 996, 1005, Fed. Sec. L. Rep. (CCH) P 94570 (N.D. Cal. 2008)(striking allegations drawn from an SEC complaint); *Geinko v. Padda*, Fed. Sec. L. Rep. (CCH) P 91711, 2002 WL 276236, *5-6 (N.D. Ill. 2002)(dismissing complaint containing allegations drawn from an SEC complaint and other civil complaints).
 30. *Connetics Corp.*, 542 F. Supp. 2d at 1005 (quoting *Pavelic & LeFlore v. Marvel Entertainment Group*, 493 U.S. 120, 110 S. Ct. 456, 107 L. Ed. 2d 438, R.I.C.O. Bus. Disp. Guide (CCH) P 7378, 15 Fed. R. Serv. 3d 1 (1989)).
 31. *Geinko*, 2002 WL 276236 at *6.

Largest Options Backdating Class Action Settlements

BY RISKMETRICS GROUP

On May 5, a \$173 million settlement was announced in the options backdating litigation involving Maxim Integrated Products, Inc.

The Maxim settlement was the 28th reached out of the 39 options backdating cases that were filed as securities class actions. Of the remaining litigations, eight have been dismissed and three await resolution. The Maxim settlement was the third largest thus far and only the seventh to top \$100 million, according to data from RiskMetrics Group. (See chart below.)

The options backdating settlements are averaging almost \$80 million, although that amount is skewed slightly by the outsized \$925.5 million settlement involving UnitedHealth Group, Inc., reached in July 2008. Without the UnitedHealth settlement added in, the average settlement drops to about \$52 million.

Option Backdating Class Action Litigation Settlements That Topped \$100 Million

Case	Settlement Date	Settlement Amount (mil.)
UnitedHealth Group, Inc.	7/2/2008	\$925.5
Converse Technology, Inc.	12/17/2009	\$225
Maxim Integrated Products	5/5/2010	\$173
Juniper Networks, Inc.	2/11/2010	\$169
Broadcom Corp.	12/29/2009	\$160.5
Brocade Communications Systems	6/2/2008	\$160
Mercury Interactive Corp.	10/15/2007	\$117.5

Source: RiskMetrics Group

Need for Attribution— Second Circuit Affirms that Plaintiffs Need to Show Reliance on Secondary Players’ Own Statements

BY CHRISTIAN SIEBOTT

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In *Pacific Investment Management Co. LLC v. Mayer Brown LLP*,¹ the Second Circuit held that a secondary actor can be liable in a private action under § 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 10b-5(b),² only for false statements attributed to the secondary-actor at the time the statement is disseminated. The court reasoned that absent attribution, plaintiffs could not show that they relied

on defendants’ own false statements, and creating those statements amounted to mere aiding and abetting, which, under *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*³ cannot form the basis of a securities fraud claim.

The court also held that claims under Rule 10b-5(a) & (c) against an undisclosed participant in a scheme to defraud investors are barred by the Supreme Court’s holding in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*⁴

Refco, Inc. was a large brokerage and clearing firm. For 20 years, Joseph Collins served as Refco, Inc.’s, outside counsel, including 10 years as a partner at Mayer Brown LLP. After suffering significant losses in the late 1990s, Refco and Mayer Brown manufactured a series of sham loan transactions in order to conceal the losses. Ultimately, in 2005, Refco declared bankruptcy.

Plaintiffs—investors in Refco securities—brought suit under § 10(b) alleging that between 2000 and 2005, Mayer Brown and Collins participated in 17 sham transactions. Specifically, Mayer Brown and Collins negotiated the terms of the loans, drafted and revised loan documents, transmitted the documents to the participants, and retained custody of, and distributed executed copies. Plaintiffs also alleged that Mayer Brown was responsible for false statements that appeared in three Refco documents: (1) an offering memorandum for an unregistered bond offering in July 2004; (2) a registration statement for a later bond offering; and (3) a registration statement for the initial public offering of common stock in August

2005. The documents were false or misleading because they failed to disclose Refco's true financial condition, which was concealed by the sham loan transactions. Although two of the documents listed Mayer Brown as counsel, none attributed any specific information to Mayer Brown or Collins.

The district court (Judge Gerard E. Lynch, since elevated to the Second Circuit) dismissed plaintiffs' claims against Mayer Brown and Collins. In deciding *In re Refco, Inc. Sec. Litig.*,⁵ the district court held that, because no statements in Refco's public documents were attributed to Mayer Brown or Collins, at most plaintiffs had alleged conduct akin to aiding and abetting—for which, under *Central Bank*, there is no private right of action under securities laws. The district court also dismissed plaintiffs' Rule 10b-5(a) and (c) claims for "scheme liability" as foreclosed by the Supreme Court's decision in *Stoneridge*.⁶

On appeal, both the plaintiffs and the Securities & Exchange Commission, writing as *amicus curiae*, argued that that a defendant can be liable for creating a false statement that investors rely on, regardless of whether that statement is attributed to the defendant at the time of dissemination. Defendants responded that attorneys who participate in the drafting of false statements could not be liable for a primary violation of Rule 10b-5(b) absent explicit attribution at the time of dissemination.

The Second Circuit affirmed. The court remarked that there were two lines of cases discussing secondary actors' liability. In *Wright v. Ernst & Young LLP*,⁷ the court held that "a secondary actor cannot incur primary liability under [Rule 10b-5] for a statement not attributed to that actor at the time of its dissemination." *Wright* involved claims that an accounting firm had orally approved a corporation's false and misleading financial statements, which were subsequently disseminated to the public. In *Lattanzio v. Deloitte & Touche LLP*,⁸ the court reiterated the attribution requirement for secondary actors' liability. In contrast, in *In re Scholastic Corp. Securities Litigation*,⁹ the court held that a corporate officer who was involved in the drafting, producing, reviewing, and disseminating of false and misleading statements may be liable for misrepresenta-

tions made by the corporation, even though none of the statements were specifically attributed to him when disseminated.¹⁰

Rejecting the 'Creator' Standard

In *Pacific Investment*, the Second Circuit firmly adopted the attribution requirement and rejected the "creator" standard urged by the plaintiffs and the SEC. Noting that "[a]ttribution is necessary to show reliance," the court reasoned that the attribution requirement was more consistent with the Supreme Court's emphasis on the element of reliance in *Stoneridge*. The court suggested that an attribution requirement was preferable because it established a "bright line" rule, as opposed to the "substantial participation" rule stated in *Wright*. The court explicitly declined to reconcile *Wright* and *Scholastic*, stating in a footnote that, because the case did not involve claims against corporate insiders, it would "intimate no view on whether attribution is required for such claims or whether *Scholastic* can be meaningfully distinguished from *Wright* and *Lattanzio*."

Noting that "[a]ttribution is necessary to show reliance," the court reasoned that the attribution requirement was more consistent with the Supreme Court's emphasis on the element of reliance in Stoneridge.

The court also affirmed the dismissal of plaintiffs' Rule 10b-5(a) and (c) claims on the ground that the Supreme Court's decision in *Stoneridge* foreclosed plaintiffs' theory of "scheme liability." The court held that under *Stoneridge*, a claim for scheme liability will not lie unless the plaintiff alleges reliance on the defendants' own deceptive conduct. Because the plaintiffs admitted that at the time of their purchases they were "unaware of defendants' deceptive conduct or 'scheme,'" the court reasoned, they could not show reliance. The court expressly rejected the argument that reliance occurs when a secondary actor's deceptive

course of conduct is communicated to the public through a company's financial statement. The court acknowledged that under its interpretation of *Stoneridge*, "it is somewhat unclear how the deceptive conduct of a secondary actor could be communicated to the public and yet remain 'deceptive.'" "

In a concurring opinion, Judge Barrington Parker invited a petition for rehearing *en banc*. "In light of the importance of the existence, *vel non*, of an attribution requirement to the securities laws, the bar, and the securities industry, this case could provide our full Court, as well as, perhaps, the Supreme Court, with an opportunity to clarify the law in this area."

NOTES

1. *Pacific Inv. Management Co. LLC v. Mayer Brown LLP*, Fed. Sec. L. Rep. (CCH) P 95722, 2010 WL 1659230 (2d Cir. 2010).
2. The Securities Exchange Act of 1934, 15 U.S.C.A. § 78j(b); and Rule 10b-5(b), 17 C.F.R. § 240.10b-5, respectively.
3. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119, Fed. Sec. L. Rep. (CCH) P 98178 (1994).
4. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 128 S. Ct. 761, 169 L. Ed. 2d 627, Fed. Sec. L. Rep. (CCH) P 94556 (2008).
5. *In re Refco, Inc. Securities Litigation*, 609 F. Supp. 2d 304, 311-314 (S.D. N.Y. 2009), *aff'd*, Fed. Sec. L. Rep. (CCH) P 95722, 2010 WL 1659230 (2d Cir. 2010).
6. See *Refco*, 609 F. Supp. 2d at 314-319.
7. *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175, Fed. Sec. L. Rep. (CCH) P 90266 (2d Cir. 1998).
8. *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, Fed. Sec. L. Rep. (CCH) P 94150 (2d Cir. 2007).
9. *In re Scholastic Corp. Securities Litigation*, 252 F.3d 63, Fed. Sec. L. Rep. (CCH) P 91455 (2d Cir. 2001).
10. *Scholastic*, 252 F.3d at 75-76.

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