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GOVERNMENT RELATIONS
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INTERNATIONAL
LABOR RELATIONS & EMPLOYMENT
MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
TAX (INTERNATIONAL, FEDERAL AND STATE)
TELECOMMUNICATIONS & UTILITIES
TRUSTS, ESATES & PERSONAL PLANNING
VENTURE CAPITAL & EMERGING COMPANIES
WHITE COLLAR CRIME

Fifth Circuit Clarifies Pleading Standards for Securities Class Actions

In two recent decisions, the Fifth Circuit clarified its interpretation of pleading requirements for securities class-action litigation under the Public Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (Dec. 22, 1995) ("Reform Act"). Congress passed the Reform Act in an effort to stem the number and effect of securities class-action "strike suits" filed against issuers, their officers/directors, and underwriters.

"Strong Inference" of Scienter

During 2001, the Fifth Circuit issued its first opinion addressing the Reform Act's requirement that complaints must plead facts demonstrating a "strong inference" of *scienter* (guilty state of mind). *See* 15 U.S.C. §78u-4 (b). In *Nathenson v. Zonagen*, 267 F. 3d 400 (5th Cir. 2001), the Circuit had reaffirmed its pre-Reform-Act holdings that *scienter* generally could be met by pleading and proof of "severe recklessness" and that Fed. R. Civ. P. 9(b) requires that securities-fraud complaints include particular facts showing the "who, what, when, where and why" fo the alleged fraud. The Fifth Circuit aligned with other "middle-ground" Circuits in holding that allegations of "motive and opportunity" to commit fraud were not sufficient (standing alone), but might combine with other allegations of *scienter,* to meet the Reform Act's "strong inference" requirement.

Rule 9(b) Particularity and "Information and Belief" Allegations

This May, the Circuit revisited the application of Rule 9(b) to post-Reform-Act complaints, holding a securities class-action plaintiff must specify: (1) each allegedly fraudulent statement; (2) who made it; (3) when and where; (4) what was false about it; (5) what the speaker gained; (6) why it was false; and additionally for "information and belief" allegations, (7) sufficient facts supporting the belief. The Court held that plaintiffs need not name confidential sources for their "information and belief" allegations, *so long as* other facts in the complaint (for example, documentary evidence or a more generalized description of the confidential source) provided adequate and facially-reliable support for the allegations of falsity. *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F. 3d 336 (5th Cir. 2002)(affirming dismissal). *See also* 15 U.S.C. §78u-4(b)(1).

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BANKING, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
BUSINESS & COMMERCIAL LITIGATION
COMMERCIAL LENDING & FINANCE
CONSTRUCTION
CORPORATE & SECURITIES
EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
ENERGY
ENVIRONMENTAL & TOXIC TORTS
ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
GAMING
GOVERNMENT RELATIONS
HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
INTELLECTUAL PROPERTY & E-COMMERCE
INTERNATIONAL
LABOR RELATIONS & EMPLOYMENT
MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
TAX (INTERNATIONAL, FEDERAL AND STATE)
TELECOMMUNICATIONS & UTILITIES
TRUSTS, ESATES & PERSONAL PLANNING
VENTURE CAPITAL & EMERGING COMPANIES
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Accounting Cases

More recently in a case especially appropriate in the wake of today's accounting-scandal headlines, the Fifth Circuit held that inaccurate financial statements or mere noncompliance with Generally Accepted Accounting Principles (GAAP) was not sufficient to meet the "strong inference" standard; instead, accounting-fraud allegations must demonstrate knowing or severely reckless behavior, corroborated by particularized factual allegations of conflicting information available to defendants at the time of the misstatement. *Abrams v. Baker Hughes, Inc.*, 292 F. 3d 424 (5th Cir. 2002) (restatement and admitted GAAP violation insufficient, affirming dismissal). The *Abrams* Court also held that several common "motive and opportunity" allegations did not meet the Reform Act's "strong inference" standard: (1) The need to raise additional capital; (2) The need to protect incentive compensation; of (3) Insider stock sales that are not suspicious in timing or amount (e.g. only one of several insiders selling). Several additional accounting cases are pending throughout the Circuit.

TWO CIRCUITS AFFIRM SANCTIONS AGAINST SECURITIES CLASS-ACTION PLAINTIFFS

The Reform Act also requires District Courts to make mandatory Rule 11 findings and conclusions – and provides for mandatory sanctions – upon the final disposition of any Reform Act litigation. Moreover, the Act also provides a presumption of full cost-of-defense sanctions in most cases of "substantial" Rule 11 violations. *See* 15 U.S.C. §78u-4(c). Unfortunately, this statutory requirement seems honored most in the breach: Defendants and Courts often are content with dismissals and Plaintiffs are eager to ignore the requirement. Two recent Court of Appeals decisions have focused on this requirement.

This July, the Eleventh Circuit affirmed the award of sanctions on finding plaintiffs "were deliberately indifferent to the lack of evidentiary support for the conclusory allegations" in a Reform-Act class litigation against Kos Pharmaceuticals, but remanded to the District Court for a small reduction in the $520,091.82 sanction amount to remove the costs of defense attributable to the lone non-frivolous claim. *Oxford Asset Management, Ltd. v. Jaharis*, 2002 U.S. App. LEXIS 14325 (11th Cir., July 16, 2002)(affirming dismissal of entire complaint asserting claims under §§11, 12(2) and Rule 10b-5). The *Jaharis* Court did not undertake a detailed analysis of the Re-

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form Act's sanction requirements.

The Second Circuit addressed that issue in greater depth this August. In *Gurary v. Nu-Tech Bio-Med, Inc.*, No.01-7969 (2d Cir. 8/23/2002), the Second Circuit applied these Reform Act sanction provisions to a complaint having both frivolous and non-frivolous (though barely) claims. The *Gurary* majority set out the following paradigm for a district court's mandatory findings:

(1) Did the complaint or any other pleading violate Rule 11(b) in whole or part?

(2) If it was an "other pleading," then Court must award only those sanctions directly attributable to the violation.

(3) If it was a complaint, was the violation "substantial" (that is, did the non-frivolous claims have potential to prevail or were they instead patently meritless and just short of frivolous thus rendering the whole suit abusive)?

(a) If yes, then the Reform Act imposes a presumption requiring an award of the defendants' full fees and costs of defense in the entire action (including any appeals); unless

(i) the violation was *de minimus* in context, thus rebutting the presumption; or full fees and costs would pose an unreasonable burden (after balancing the hardships on all parties), then

(ii) the court must award "appropriate" sanctions.

(b) If no, then the court must award "appropriate" sanctions.

Note that the Eleventh Circuit's *Jaharis* decision also dealt with a complaint containing a lone non-frivolous claim not preventing dismissal, but failed to address the presumption or the full-cost-of-defense provision, thus setting up a potential Circuit conflict.

SARBANES-OXLEY EXTENDS SECURITIES-LITIGATION LIMITATIONS

The recent Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (July 30, 2002) affects private securities litigation and counsel in several ways:

Longer Limitations Period for *Some* Cases

Section 804 of the Act (in the "Corporate & Criminal Fraud Accountability Act of 2002" subchapter) amends the federal catch-all limitations period in 28 U.S.C. §1658 to add a new subsection (b) establishing a 2-year

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AVIATION
APPELLATE LITIGATION
BANKING, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
BUSINESS & COMMERCIAL LITIGATION
COMMERCIAL LENDING & FINANCE
CONSTRUCTION
CORPORATE & SECURITIES
EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
ENERGY
ENVIRONMENTAL & TOXIC TORTS
ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
GAMING
GOVERNMENT RELATIONS
HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
INTELLECTUAL PROPERTY & E-COMMERCE
INTERNATIONAL
LABOR RELATIONS & EMPLOYMENT
MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
TAX (INTERNATIONAL, FEDERAL AND STATE)
TELECOMMUNICATIONS & UTILITIES
TRUSTS, ESATES & PERSONAL PLANNING
VENTURE CAPITAL & EMERGING COMPANIES
WHITE COLLAR CRIME

limitations and 5-year repose period for "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." Though clearly targeted at Rule 10b-5 cases, the provision is poorly drafted and arguably creates a conflict with the 1-year limitations, 3-year repose periods for misrepresentation claims not requiring *scienter*, for example sections 11 and 12. *See* 15 U.S.C. §§77m, 78v.

<u>Securities-Litigation Judgments & Settlements Nondischargeable</u>

Section 803 of the Act amends 11 U.S.C. §523(a) to render nondischargeable in bankruptcy any debt that is for (a) a violation of federal or state securities law, regulation or order, or (b) common-law fraud, deceit or manipulation in connection with the purchase or sale of any security and results from a judgment, order, decree, or settlement agreement. The provision may not cover amounts paid for or expressly allocated to other *non-scienter* claims commonly asserted in securities litigation, such as breach of duty (fiduciary or not) or negligence.

<u>Attorney's Obligation to Report Misconduct</u>

Section 307 of the Act requires immediate SEC rule-making requiring attorneys practicing before the SEC to report "evidence of a material violation of securities law or breach of fiduciary duty or similar violations" to an entity's chief legal officer or CEO and thence to the Board if the "officer does not appropriately respond." This requirement differs from Model Rule of Professional Conduct in three key respects. First, the Model Rule required the misconduct to be "likely to result in substantial injury to the organization" to be reportable, while the Act simply requires it be "material." Second, the Model Rule provided outside counsel the opportunity to balance disclosure against organizational risk and permitted the lesser options of urging reconsideration or issuing a separate legal opinion, before referring the matter to higher authority. Third, unlike the Model Rule, the Act requires outside counsel to evaluate the "appropriateness" of the corporate officer's response in determining whether to report it to the Board, thus posing a risk of hindsight-liability.

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EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
ENERGY
ENVIRONMENTAL & TOXIC TORTS
ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
GAMING
GOVERNMENT RELATIONS
HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
INTELLECTUAL PROPERTY & E-COMMERCE
INTERNATIONAL
LABOR RELATIONS & EMPLOYMENT
MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
TAX (INTERNATIONAL, FEDERAL AND STATE)
TELECOMMUNICATIONS & UTILITIES
TRUSTS, ESATES & PERSONAL PLANNING
VENTURE CAPITAL & EMERGING COMPANIES
WHITE COLLAR CRIME

NASDR AND IRS TEAM IN INVESTIGATION OF POOLED MUNICIPAL FINANCINGS

The Bond Buyer reported August 21 that the NASDR and IRS "may soon join forces to crack down on what appear to a growing number of abusive blind-pool transactions, some of which surfaced during the previous yield-burning controversy." The IRS reports it is auditing some 10 deals (including some in Kentucky and Ohio), with another 10-20 on its radar. The *Bond Buyer* noted NASDR's interest in the subject and its refusal to comment. We are aware, however, of current NASDR investigations underway in, and coordinated by a special investigative team at, NASDR District V in New Orleans.

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact our Corporate and Securities Litigation practice group:

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