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WHITE COLLAR CRIME

## PRIVATE SECURITIES LITIGATION

Private securities class-action litigation increased 17% during 2004, while settlement amounts grew even faster, according to “year in review” reports by both Cornerstone Research ([www.cornerstone.com](http://www.cornerstone.com)) and PriceWaterhouseCoopers ([www.10b5.com](http://www.10b5.com)). A similar study by NERA Economic Consulting ([www.nera.com](http://www.nera.com)) concluded mean settlements are up 33% and companies have a 10% chance of facing a securities class action over each 5-year period. While most suits continue to involve accounting issues and financial-statement disclosures, several trends are worth noting:

- follow-on claims from regulatory inquiries over non-accounting business practices are yielding a growing number of suits over omissions allegedly inflating results by masking “known problems,” for example bid-rigging in the insurance industry and mutual-fund pricing, trading and sales practices.
- the plaintiffs’ bar has developed securities class-action clones from product-liability cases, as in the new filings over failure to disclose “known” health risks of COX-2 inhibitors.
- PWC cites cases against emerging-markets issuers and SEC actions to apply Sarbanes-Oxley requirements against foreign issuers as part of a growing trend of globalization in securities regulatory and civil disputes.
- Filings increased in the 5<sup>th</sup> Circuit, which now ranks 4<sup>th</sup> in number of filings.

## RECENT DEVELOPMENTS

### Fraud on the Market: Loss Causation Requires Pleading and Proving Diminished Value, Not Just Inflated Price

The US Supreme Court pulled the 9<sup>th</sup> Circuit back into line with the prevailing view of the 2<sup>nd</sup>, 3<sup>rd</sup>, and 7<sup>th</sup> Circuits, by requiring that fraud-on-the-market plaintiffs plead and prove diminished value after the truth is revealed and rejecting a simple “inflated price” allegation. In *Dura Pharmaceutical, Inc. v. Broudo*, No. 03-932, 544 U.S. \_\_\_\_ (US, Apr. 19, 2005), the Court reversed a 9<sup>th</sup> Circuit opinion that had let stand an amended class action complaint alleging only that misrepresentations had “inflated the purchase price” of the stock and “caused damages.” Noting that the market price might not decline or might decline for reasons other than the alleged misrepresentation, the Court held that both the common-law and the PSLRA’s statutory loss-causation requirements mandated “some indication of the [subsequent] loss and the causal connection that the plaintiff has in mind.” The Court also noted that by focusing solely upon the point of purchase, the 9<sup>th</sup> Circuit’s opinion had improperly conflated transaction and loss causation.

The Court’s opinion has a good recapitulation of the required elements of a Rule 10b-5 claim. The Court roundly rejected the 9<sup>th</sup> Circuit’s vague language that the misrepresentation need only “touch upon” the loss, rather than proximately cause it.

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### Fraud on the Market: Fifth Circuit Requires More Evidence and Better Analysis of Efficient Market for Class Certification

In *Unger v Amedisys, Inc.*, 410 F.3<sup>rd</sup> 316 (5<sup>th</sup> Cir. Feb. 17, 2005), the 5<sup>th</sup> Circuit reversed class certification in a fraud-on-the-market case involving an OTC Bulletin-Baord-traded stock for insufficient evidence to support the "efficient-market" hypothesis underlying the rebuttable-presumption that substitutes for reliance.

The Court required a "rigorous analysis" that goes beyond the pleadings, with a burden of proof akin to that in preliminary injunction hearings, of the various factors bearing upon whether the stock traded in an "efficient market": (1) trading volume as a percentage of total outstanding shares; (2) analyst following; (3) market makers and arbitrageurs trading the stock; (4) eligibility to file SEC form S-3; (5) empirical facts showing a cause and effect relationship between company news and its stock price; (6) the issuer's market capitalization; (7) bid-ask spread; and (8) float. In this case, the district court improperly relied on mere allegations in the pleadings, one-sided affidavits not subject to cross-examination and internet print-outs.

*Unger* raises the bar on securities class actions by forcing plaintiffs to provide greater proof of fraud on the market, especially against those defendants with smaller float, who are not on major exchanges. Plaintiffs cannot avoid proving individual reliance by conclusory "fraud on the market" and "efficient market" allegations.

-Sarah B. Belter

### Weaker Allegations of Motive Require Stronger Circumstantial Evidence For *Scienter*

In *R2 Investments LDC v. Phillips, et al.*, Fed. Sec. L. Rep. (CCH) ¶93, 127 (5<sup>th</sup> Cir., Mar. 1, 2005), the 5<sup>th</sup> Circuit affirmed the dismissal of shareholders' putative 10b-5 class action for failure to allege facts raising the "strong inference" of *scienter* required by the PSLRA's heightened pleading requirements. R2 Investments sued the officers and directors of World Access, Inc., for the failure to disclose that it did not have the cash, or was relying on risky contingencies, to make the payments required to complete its tender offer obligations and continue operating.

Building on its prior holdings in *Tuchman* and *Natheson* regarding the role of motive in the *scienter* element, the 5<sup>th</sup> Circuit held that, without allegations of a *clear* motive for the alleged misstatement/omission, the strength of the circumstantial evidence must be correspondingly greater. Assuming as true that some defendants may have known World Access would not have the cash to repurchase the notes, this alone was not enough to raise a strong inference that the defendants knew or suspected World Access would not complete its repurchase obligations.

The 5<sup>th</sup> Circuit's holding suggests a sort of inverse sliding scale for allegations of motive and circumstantial evidence of *scienter*: The clearer and stronger the allegations of motive, the lesser the strength of circumstantial evidence required. Vague or lacking "motive" allegations require stronger circumstantial evidence to raise an inference of *scienter*.

-Stacie M. Hollis

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### Statistical Tracing Insufficient for Section 11 Standing

Section 11 imposes virtually per-se liability on public issuers for misstatements in registration statements, and stringent liability on underwriters (subject to a "due diligence" defense). Because they do not require fraudulent intent, Section 11 claims often are not subject to the pleading requirements of the PSLRA. While the 3<sup>rd</sup> and 7<sup>th</sup> Circuits limit standing only to direct purchasers in initial distributions, many Circuits (including the 5<sup>th</sup>) allow standing for aftermarket purchasers who can "trace" their shares to the offering.

In the first case to deal with the evidentiary obstacles to "tracing" aftermarket shares held in street name, *Krim v. pcOrder.com, Inc.*, Fed. Sec. L. Rep. (CCH) ¶196,126 (5<sup>th</sup> Cir. Mar. 1, 2005), the 5<sup>th</sup> Circuit rejected statistical evidence proving only the probability (though very high) of attribution to the offering as insufficient to carry plaintiffs' burden of "tracing" the shares. If used to contest the usual vague allegations of "traceability," the decision should substantially restrict Section 11 standing and markedly decrease the likelihood of class certification (and/or class size, if certified).

### ARBITRATION AND MEDIATION

As of March 28, 2005, NASD has expanded its arbitration and mediation centers to all 50 states, increasing travel for hearings at the location nearest claimant.

The Ninth Circuit recently held that the '34 Act and Commission approval of NASD's arbitration procedures pre-empt conflicting state laws, specifically California's strict arbitrator disclosure requirements. *Credit Suisse First Boston Corp. v. Grunwald*, 400 F. 3d 1119 (9<sup>th</sup> Cir. Mar. 1, 2005).

### REGULATORY ENFORCEMENT

PWC's 2004 review of securities litigation (cited above) notes that SEC (and similar DOJ) investigations and enforcement actions continue at record-setting levels --- both in number, and in the size of disgorgement and penalties. The report also cites increasing pressure on independent directors, including the conduct of independent internal investigations.

NY Attorney General Spitzer has criticized the SEC and recent SEC releases express increasing concern over various SRO practices. In perhaps another sign of increasing regulatory friction, for the first time in over 70 years of existence, the NASD has appealed an SEC decision overturning an SRO disciplinary decision. The SEC has moved to dismiss, arguing that NASD has no standing to appeal. *NASD v. SEC*, No. 04-1154 (D.C. Cir.). Briefing is complete and the case is pending oral argument.

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*Please 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 about these issues, please contact:*

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