Skadden

Inside the Courts

An Update From Skadden Securities Litigators

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AUCTION RATE SECURITIES

Wilson v. Merrill Lynch & Co., Inc., No. 10-1528-cv (2d Cir. Nov. 14, 2011)

Click here to view the opinion.

Second Circuit Affirms Dismissal of Market Manipulation Claims

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that Merrill Lynch violated Section 10(b) of the Securities Exchange Act by allegedly manipulating the market for auction rate securities by placing bids to prevent auction failures. The court recognized that Merrill Lynch adequately disclosed that it "routinely" placed bids on its own account, and that it may do so to prevent auctions from failing. Consequently, those disclosures were sufficient to avoid liability because the disclosure placed a reasonable investor on notice that Merrill Lynch might place bids on its own account.

Fishman v. Morgan Keegan & Co., No. 10-2-CJB-JCW (E.D. La. Oct. 13, 2011)

Click here to view the opinion.

Eastern District of Louisiana Rejects Investor Suit Regarding Morgan Keegan ARS Risks Following Trial

Judge Carl J. Barbier of the U.S. Court for the Eastern District of Louisiana issued findings of fact and conclusions of law, following a two-day bench trial, rejecting claims that Morgan Keegan & Co. Inc. duped investors into buying auction rate securities (ARS) by representing them as safe and liquid investments. At trial, the plaintiffs asserted claims under Section 10(b) of the Securities Exchange Act, SEC Rule 10b-5, and Louisiana's Blue Sky Law alleging that Morgan Keegan misled investors about the risks of ARS and failed to disclose that it managed auctions in which its securities were sold. The district court determined that, even assuming that Morgan Keegan did make material misstatements or omissions, the plaintiffs failed to establish that they ever relied on any representation made by the company, as required under Section 10(b). The plaintiffs maintained no accounts with Morgan Keegan and never actually communicated with anyone there prior to the purchase of the securities. Moreover, the plaintiffs did not introduce evidence proving the existence of a "chain of reliance" whereby the plaintiffs relied upon a separate registered investment adviser who in turn relied upon Morgan Keegan. Nor did the plaintiffs submit the evidence required to invoke the fraud-on-the-market presumption of reliance. The court further determined that the plaintiffs failed to establish loss causation, because corrective disclosures regarding the liquidity risks of ARS and Morgan Keegan's participation in the auctions were disseminated to the market on multiple occasions.

CLASS CERTIFICATION

Damasco v. Clearwire Corp., No. 10-3934 (7th Cir. Nov. 18, 2011)

Click here to view the opinion.

Seventh Circuit Affirms Dismissal of Class Action Where Defendant Tenders Requested Relief Before Motion for Class Certification

The U.S. Court of Appeals for the Seventh Circuit upheld the dismissal of a complaint where a defendant's offer of full relief to the named plaintiff prior to class certification mooted the plaintiff's claims. The plaintiff filed a complaint in Illinois state court, complaining that Clearwire violated the Telephone Consumer Protection Act by sending unwanted text messages to consumers. Before the plaintiff moved for class certification, Clearwire offered to settle the case by providing full relief to the named plaintiff. Clearwire then removed the case to federal court and argued that the offer mooted the plaintiff's claim. The district court agreed and dismissed the complaint. In so holding, the district court noted that "the rule in Seventh Circuit is clear — a complete offer of settlement made prior to the filing for class certification moots the plaintiff's claim."

The Seventh Circuit upheld the dismissal and refused to create an exception to the mootness doctrine in potential class actions where defendants offer relief to named plaintiffs before the plaintiffs have a reasonable opportunity to seek certification. Although the court noted that

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four circuits have fashioned a new rule allowing plaintiffs to certify a class and avoid mootness after an offer of full relief due to concerns about the "buy off" of named plaintiffs, the court refused to reverse course. The Seventh Circuit explained that allowing plaintiffs to maintain a suit without any personal stake in the litigation defied the limits on federal jurisdiction imposed by Article III. Further, plaintiffs could avoid the buy-off problem by moving to certify the class at the same time as they file a complaint. For these reasons, the Seventh Circuit refused to revise its established rule that a complete offer of settlement prior to a motion to certify a class moots a plaintiff's claim.

Conn. Ret. Plans & Trust Funds v. Amgen Inc., No. 09-56965 (9th Cir. Nov. 8, 2011)

Click here to view the opinion.

Ninth Circuit Weighs In on Circuit Split as to Whether Materiality Must Be Proved to Certify a Fraud-on-the-Market Class

The U.S. Court of Appeals for the Ninth Circuit joined the Third and Seventh Circuits in holding that plaintiffs need not prove the materiality of alleged false statements in order to certify a class in a fraud-on-the-market securities fraud case. The holding deepens an existing split between these courts and the First, Second and Fifth Circuits, which hold that materiality must be alleged *and* proved to certify a fraud-on-the-market class.

The plaintiff sued Amgen under the SEC's Rule 10b-5, alleging false statements about the safety of the company's anemia treatment products. The plaintiff moved for class certification, and Amgen opposed on the grounds that each plaintiff would need to prove individually that he relied on the alleged statements to purchase the security. Moreover, Amgen contended that the alleged misrepresentations could not have been material to the plaintiffs because the truth about the safety of Amgen's anemia products had already been disclosed to the market through U.S. Food and Drug Administration announcements and public analyst reports.

The district court granted class certification, and the Ninth Circuit affirmed, holding that in order to invoke the fraud-on-the-market presumption of reliance, a plaintiff must show only that a defendant's shares traded on an efficient market and that the alleged misrepresentation was public. Neither of those facts was contested in this case. Further, although a plaintiff must adequately allege materiality of the purportedly false statement in order to survive a motion to dismiss, he need not prove reliance at the class certification stage because reliance is an element of the fraud claim itself.

Finally, the Ninth Circuit affirmed the district court's refusal to consider Amgen's "truth-on-the-market" defense at the class certification stage. Although Amgen had come forward with evidence that the truth about its products was already public by the time of the alleged false statements, the Ninth Circuit held that Amgen's evidence went to the merits of materiality, and it was improper to consider it at the class certification stage.

The Ninth Circuit denied Amgen's motion for an en banc rehearing on December 28, 2011.

CONFIDENTIAL INFORMANTS

Plumbers & Pipefitters Local Union No. 630 Pension-Annuity Trust Fund v. Arbitron, Inc., No. 08 Civ. 4063 (PAE) (S.D.N.Y. Nov. 14, 2011)

Click here to view the opinion.

S.D.N.Y. Requires Plaintiffs to Identify Confidential Informants

In a securities fraud class action, Judge Paul A. Engelmayer of the U.S. District Court for the Southern District of New York required that the plaintiffs identify 11 confidential informants used in the complaint. In response to an interrogatory, the plaintiffs argued that the confidential informants' identities were protected by the attorney work-product doctrine, although they had listed all the confidential informants on their initial disclosures (but had not identified them as such). However, this objection was rejected because the confidential informants' identities did not constitute the thought processes of the plaintiffs' attorneys, and revealing their identities

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would not reveal trial strategy. In addition, requiring the defendant to discover the information through numerous depositions would be unduly burdensome.

DIRECTORS AND DIRECTORS' DUTIES

Annual Meetings and Corporate Elections

Sherwood v. Ngon,
C.A. No. 7106-VCP
(Del. Ch. Dec. 20, 2011)

Click here to view the opinion.

Court of Chancery Temporarily Enjoins Annual Meeting to Enable Director to Solicit Proxies for Competing Board Slate

Vice Chancellor Donald F. Parsons of the Delaware Court of Chancery temporarily enjoined, for 20 days, ChinaCast Education Corp. and its defendant directors from holding an annual meeting, to enable the plaintiffs to solicit proxies for their competing short slate of directors, notwithstanding an advance notice bylaw provision. The order authorized the defendants to open and adjourn the annual meeting during the 20-day period for the sole purpose of complying with Del. Code tit. 8, § 213(a) (the record date provision) and required the plaintiffs to post a bond of $250,000.

One of the plaintiffs, Ned Sherwood (a director of ChinaCast), was removed from the company's slate of directors for the upcoming annual meeting. He claimed that the board breached its fiduciary duty of disclosure when communicating its reasons for taking that action. The defendants argued that Sherwood could not demonstrate any irreparable harm sufficient to justify a temporary restraining order because, among other things, the company's advance notice bylaw precluded him from initiating a proxy contest. According to the defendants, with no competing slate, there was no risk of a harmful, uninformed vote. The plaintiffs argued that the company's proxy materials failed to disclose the existence of genuine policy disputes between Sherwood and the individual defendants related to a buyback program, among other things, and instead had identified a number of other reasons for his removal, including alleged violations of certain company policies on trading. The court noted that when deciding whether or not to issue a temporary restraining order, "the Court's focus usually is less upon the merits of the plaintiff's legal claim than on the relative harm to the various parties if the remedy is or is not granted." Further, "this 'less exacting merits-based scrutiny' derives from a realistic appreciation of the short-term duration of the remedy and the limited factual record generally available at such an early stage in the proceeding." The court concluded that the manner and timing in which Sherwood was removed from the company's slate — initially nominating him, removing him only days before the annual meeting and arguing that the company's advance notice bylaw prevents him from nominating an opposing slate — arguably supports an inference that self-interested reasons also motivated the individual defendants' decision to remove him. Because that conceivably could be the case, the proxy supplement may be materially misleading in its failure to disclose the board's motivations candidly.

The court also concluded that the company's disclosures relating to an SEC investigation of Sherwood's trading activity presented at least a colorable disclosure claim. In addition, the court concluded that the advance notice bylaw provision was arguably ambiguous and that "there is a fair possibility that Plaintiffs can nominate an opposing slate consistent with the company's bylaws," and "[t]hat possibility, together with the certainty that federal regulations guarantee Plaintiffs will lose their proxy contest absent a TRO, supports [the court's] conclusion that Plaintiffs have demonstrated the existence of irreparable harm if a TRO is not granted." The court therefore concluded that "Defendants have not simply expressed their disagreement with Sherwood's positions or dissatisfaction with his personal behavior; they also have excluded him from merely running for election. In this way, holding the Annual Meeting on December 21 would not comport with the 'scrupulous fairness' required of corporate elec-

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tions. Thus, the interests of corporate democracy on which Plaintiffs rely have the greatest effect on the balance of the equities in this case. And, that effect favors granting the TRO."

Books and Records

Cent. Laborers Pension Fund v. News Corp., C.A. No. 6287-VCN (Del. Ch. Nov. 30, 2011)

Click here to view the opinion.

Court of Chancery Dismisses Section 220 Action Filed Immediately After Derivative Action

Vice Chancellor John W. Noble of the Delaware Court of Chancery dismissed the plaintiff's action to inspect certain books and records of defendant News Corp. under Del. Code tit. 8, § 220. Following News Corp.'s announcement that it would acquire Shine Group Ltd., the plaintiff made a written demand to inspect books and records for the purpose of investigating potential breaches of fiduciary duty in connection with the acquisition, and to determine whether making a presuit demand was necessary. Thereafter, the plaintiff commenced a derivative proceeding in the Court of Chancery and commenced the Section 220 action to enforce the inspection demand. The defendant moved to dismiss the Section 220 action because "the simultaneous filing of the Derivative Action refutes any claim of a proper purpose for [plaintiff's] inspection demand."

In dismissing the Section 220 action, the court explained that "the stockholder plaintiff who files a Section 220 action immediately after its derivative action is acting inconsistently" because "by filing its derivative complaint, [a plaintiff] acknowledge[s] — if, for no other reason than to satisfy its lawyers' Rule 11 obligations — that it had sufficient information to support its substantive allegations and its allegations of demand futility ... ." The court further explained that it "routinely stays discovery in derivative actions while non-frivolous motions to dismiss are resolved. ... Section 220 was not adopted as a substitute for litigation discovery ... ." In dismissing the Section 220 action the court distinguished *King v. Verifone Holdings, Inc.*, 12 A.3d 1140 (Del. 2011) [see *Inside the Courts,* Vol. 2, Issue 2], explaining that in *Verifone*, a judicial determination that derivative allegations "were not sufficient coupled with the judicially-granted leave to amend ... eliminated the inconsistency" present here. The plaintiff has appealed the dismissal.

Derivative Litigation

Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, C.A. No. 425, 2011 (Del. Dec. 28, 2011)

Click here to view the opinion.

Delaware Supreme Court Finds Plaintiff Failed to Satisfy Demand Requirements of Spanish Law

The Delaware Supreme Court, sitting en banc with Justice Jack B. Jacobs writing for the court, affirmed the ruling of the Delaware Court of Chancery that the plaintiff lacked standing to pursue derivative claims because it failed to satisfy the demand requirements of Spanish law. Sagarra, the sole minority shareholder of the Spanish Corporacion Uniland S.A., brought suit to rescind Cementos Portland Valderrivas' sale of Giant Cement Holdings, Inc. to Uniland. Cementos was the controlling stockholder of both Giant and Uniland at the time of the sale. Sagarra purported to sue derivatively on behalf of UAC, a wholly owned Delaware subsidiary of Uniland, specifically created as the vehicle to acquire Giant. The court held that "Sagarra's standing to sue derivatively on behalf of UAC must necessarily derive from its ownership of shares of Uniland, because Uniland is the only corporation in which Sagarra owns shares. Without that ownership stake, Sagarra would have no basis to claim standing to sue on behalf of any entity within the Uniland corporate hierarchy." The court then applied Spanish derivative standing law because Uniland was incorporated under the laws of Spain. The court explained that the "internal affairs doctrine is a dominant and overarching choice of law principle" that "prevent[s] corporations from being subjected to inconsistent legal standards ... ." Because "[t]he presuit demand requirement is quintessentially an 'internal affair,'" the court found Spanish law applied. Thus, because Sagarra failed to first comply with the presuit demand requirements of Spanish corporate law, it had no standing to pursue a multi-tier derivative action on behalf of a Delaware subsidiary in the Delaware courts.

In re Compellent Techs., Inc. S'holder Litig., Consol. C.A. No. 6084-VCL (Del. Ch. Dec. 9, 2011)

Click here to view the opinion.

Mergers and Acquisitions

Court of Chancery Awards Attorneys' Fees and Expenses for Modification of Deal Protection Provisions

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery issued a lengthy opinion in which he awarded $2.4 million in attorneys' fees and expenses for modification of deal protection provisions, the rescission of a rights plan and supplemental disclosures. These benefits were secured in the settlement of class claims arising out of Dell Inc.'s acquisition of Compellent Technologies, Inc., a transaction valued at approximately $960 million. Despite the modified deal protections, no competing bidder emerged.

In fashioning the fee award, the court characterized the benefits generated from modifying deal protections as "an increased opportunity for stockholders to receive greater value." Accordingly, the court considered the record evidence (including expert reports and deposition transcripts) in determining the appropriate fee award for the benefit here. Ultimately, the court awarded $2.4 million in attorneys' fees and expenses for the benefits achieved by the settlement.

FOREIGN CORRUPT PRACTICES ACT

United States v. Aguilar, No. CR 10-01031(A)-AHM (C.D. Cal. Dec. 1, 2011)

Click here to view the opinion.

California Federal Court Vacates Convictions and Dismisses Indictment in FCPA Case

In the only Foreign Corrupt Practices Act criminal prosecution against a corporation to proceed to a jury trial, Judge A. Howard Matz of the U.S. District Court for the Central District of California vacated the convictions and dismissed the indictment based on prosecutorial misconduct, following the defendants' post-trial motions. The government alleged that the company and its employees paid bribes to Comision Federal de Electricidad, a state-owned utility in Mexico. The court concluded the government committed misconduct warranting dismissal by (1) failing to timely produce grand jury transcripts to the defense; (2) procuring search and seizure warrants through materially false and misleading affidavits; (3) improperly obtaining attorney-client communications; (4) violating court orders; (5) questioning witnesses improperly; (6) failing to timely produce information required under *Jenks*; and (7) engaging in questionable behavior during closing arguments. Although recognizing dismissal of the indictment is an extreme remedy, especially following a conviction, the court concluded the weakness of the government's case and the impact of the charges on the defendants warranted dismissal.

INTERPRETING *JANUS*

Munoz v. China Expert Tech., Inc., No. 07 Civ. 10531 (S.D.N.Y. Nov. 4, 2011)

Click here to view the opinion.

S.D.N.Y. Upholds Claims Against Auditor in Connection With Opinion Signed by Foreign Affiliate

On a motion to dismiss, Judge Alvin K. Hellerstein of the U.S. District Court for the Southern District of New York upheld claims that a New York-based auditor committed securities fraud by allegedly making false and misleading statements in an audit opinion signed by the auditor's Hong Kong affiliate. Although the New York auditor argued that it did not direct or control any audit activities, the plaintiffs adequately alleged that the New York auditor made the statements under *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), because the New York auditor allegedly reviewed the opinion for compliance with SEC requirements and had authority over the opinion's contents, and its managing director gave final approval before the opinions were signed.

In re Optimal U.S. Litig.,
No. 10 Civ. 4095 (SAS)
(S.D.N.Y. Oct. 13, 2011)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Against Investment Company Relating to Subsidiary's Allegedly Fraudulent Statements

In a case arising from the Bernard Madoff Ponzi scheme, Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York dismissed claims that Optimal, a Bahamian investment company, violated Section 10(b) of the Securities Exchange Act because Optimal's subsidiary — and not Optimal itself — made allegedly fraudulent statements. The alleged misstatements occurred in explanatory memorandums — Bahamian equivalents of prospectuses — issued by Optimal's wholly owned subsidiary, Multiadvisors. Although Optimal appointed Multiadvisors' board and Optimal's CEO was one of Multiadvisors' directors, under *Janus Capital Group v. First Derivative Traders*, 131 S. Ct. 2296 (2011), Optimal was not primarily liable for the alleged misstatements because Multiadvisors' board had ultimate authority over the explanatory memorandums' contents. However, in light of Optimal's 100 percent ownership of Multiadvisors, and therefore ability to control it, the plaintiffs adequately alleged control person liability under Section 20(a) of the Securities Exchange Act.

City of Roseville Emps.' Ret. Sys. v. EnergySolutions, Inc.,
No. 09 Civ. 8633 (JGK)
(S.D.N.Y. Sept. 30, 2011)

Click here to view the opinion.

S.D.N.Y. Upholds Claims Against Company and Its Former Sole Shareholder

Judge John G. Koeltl of the U.S. District Court for the Southern District of New York upheld claims that EnergySolutions and its former sole shareholder, ENV Holdings, violated Section 10(b) of the Securities Exchange Act by allegedly making material misstatements and omissions in offering documents for an IPO and a follow-on secondary offering. The plaintiffs adequately alleged that EnergySolutions made misleading statements (for example, stating that it had contracts to dispose of "substantially all" of a certain type of nuclear waste with various power plants when much of this waste was allegedly outside the contracts' scope). In addition, the plaintiffs adequately alleged that ENV Holdings was a primary actor under Section 10(b), and the court distinguished *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), as a basis for precluding ENV Holdings' liability. Even though ENV Holdings was a separate entity, and all offering documents were made by EnergySolutions alone, the court observed that ENV Holdings purportedly was EnergySolutions' sole or controlling shareholder, and thus the court further held that it had direct control over EnergySolutions' corporate transactions, including determining whether and when to sell EnergySolutions' shares during the offerings.

LOSS AND TRANSACTION CAUSATION

Borno v. Gen. Elec. Co.,
No. 10-4284-cv
(2d Cir. Nov. 18, 2011)

Click here to view the opinion.

Second Circuit Finds Plaintiffs Failed to Adequately Plead That Loss Was Caused by the Materialization of a Concealed Risk

In a summary order, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that GE violated Section 10(b) of the Securities Exchange Act because the plaintiffs failed to adequately plead that their loss was caused by the materialization of a concealed risk. The plaintiffs alleged that GE concealed its liquidity problems and its plan to raise capital through dilutive equity financing. However, because GE's stock price rose following the announcement that it would issue new equity, the plaintiffs could not show that the allegedly concealed equity issuance caused their losses. Further, although GE's share price fell the following day in response to GE's announcement that it would sell the new shares for a price below market value, this later fall was irrelevant to the loss-causation analysis because the plaintiffs did not allege that GE concealed the offering price.

FindWhat Investor Grp. v. FindWhat.com, No. 10-10107 (11th Cir. Sept. 30, 2011)

Click here to view the opinion.

Eleventh Circuit Splits With Fifth Circuit by Holding That Confirmatory False Statements Which Have No Immediate Effect on Share Prices Are Actionable

The U.S. Court of Appeals for the Eleventh Circuit reversed a Florida district court that had granted summary judgment in favor of defendants FindWhat.com and three of its officers. In doing so, the Eleventh Circuit parted with a ruling by the Fifth Circuit about loss causation under the Securities Exchange Act. The Eleventh Circuit opinion held that "confirmatory false statements" that perpetuate an artificially inflated share price, but do not themselves immediately affect the share price, can establish causation under the SEC's Rule 10b-5. In other words, "defendants can be liable for knowingly and intentionally causing a stock price to *remain* inflated by preventing preexisting inflation from dissipating from the stock price."

The plaintiffs, who were shareholders of FindWhat.com, sued the company and three of its officers under Section 10(b) of the Securities Exchange Act, alleging false statements about how "click fraud" affected the company's sale of online advertisements. (Click fraud is the act of clicking on an online ad for the sole purpose of causing the advertiser to pay a fee to the company that sold the ad space, where the advertiser has agreed to a "pay-per-click" contract.) The plaintiffs alleged that FindWhat.com knew it had a click fraud problem caused by certain of its online distribution partners, but falsely stated on a conference call that the company had stopped associating with those distribution partners. FindWhat.com allegedly repeated that statement in its 10-K and further misleadingly represented that the company had implemented procedures to identify and prevent click fraud. When the company issued corrective disclosures, the share price dropped 21 percent in one day.

The district court had granted summary judgment on these claims because it was undisputed that FindWhat.com's share price was inflated *before* the class period and remained unchanged after the statements at issue. From this, the lower court reasoned that the alleged statements, even if knowingly and materially false, could not have "caused" the inflation in share price because the statements did not themselves result in a change in price. The Eleventh Circuit reversed, explaining that, "[a]t bottom, it is irrelevant to securities fraud liability that the stock price was already inflated before a defendant's first actionable misrepresentation; fraudulent misstatements that prolong inflation can be just as harmful to subsequent investors as statements that create inflation in the first instance." The court rejected a Fifth Circuit case that categorically held that "confirmatory information" cannot be actionable because, even if false, that information is already digested by the market and cannot further affect share price. Rather, the court opted for a less formalistic view of loss causation, explaining that "Defendants who commit fraud to prop up an already inflated stock price do not get an automatic free pass under the securities laws."

Gallup v. Clarion Sintered Metals, Inc., No. 1:08-cv-195-SJM (W.D. Pa. Sept. 30, 2011)

Click here to view the opinion.

Pennsylvania Federal Court Grants Summary Judgment in Favor of Company Accused of Failing to Disclose Sham Related-Party Transactions

Judge Sean J. McLaughlin of the U.S. District Court for the Western District of Pennsylvania granted summary judgment in favor of Clarion on claims that it violated Section 10(b) of the Securities Exchange Act, because the plaintiff, a former employee, did not adequately plead either loss or transaction causation. The former employee alleged that Clarion's financial statements did not comply with GAAP because they did not disclose transactions with a related company allegedly used to loot Clarion. However, the former employee did not show loss causation because, even if the related-party transactions were disclosed in compliance with GAAP, such disclosure would not have further disclosed that the related-party transactions were a sham used to loot Clarion. Clarion's alleged failure to disclose the related-party transactions could not, on its own, account for Clarion's purportedly suppressed share price. Similarly, because the plaintiff's claim was that he would not have sold his stock at the price for which it was sold (*i.e.*, arguably he would have received more from his stock sale) if Clarion had disclosed the related-party transactions, the plaintiff failed to show separate transaction causation.

PSLRA DISCOVERY STAY

Stanger v. China Elec. Motor, Inc., No. 2:11-cv-02794-R (C.D. Cal. Dec. 5, 2011)

Click here to view the opinion.

Gearing v. China Agritech, Inc., No. 2:11-cv-04417-RGK-PJW (C.D. Cal. Dec. 2, 2011)

Click here to view the opinion.

In re China Valves Tech. Sec. Litig., No. 11 Civ. 0796 (LAK) (S.D.N.Y. Nov. 17, 2011)

Click here to view the opinion.

In re China Educ. Alliance, Inc. Sec. Litig., No. 2:10-cv-09239-CAS-JC (C.D. Cal. Aug. 22, 2011)

Click here to view the opinion.

Judges Lift Discovery Stays in Securities Fraud Suits Against Chinese Companies

Several courts have recently lifted the discovery stays imposed by the Private Securities Litigation Reform Act during the pendency of any motion to dismiss in securities fraud class actions in cases involving Chinese-based companies that gained access to United States stock markets through reverse mergers. In these cases, individual defendants sometimes reside abroad, making service potentially difficult. Judges have attempted to combat this problem by issuing orders to facilitate service in plaintiffs' stalled cases. For example, Judge Manuel L. Real of the U.S. District Court for the Central District of California lifted the discovery stay in *Stanger v. China Electric Motor, Inc.* to allow plaintiffs to conduct discovery to obtain information to serve individual defendants with the summons and the complaint. In *In re China Education Alliance, Inc. Securities Litigation*, Judge Christina A. Snyder of the U.S. District Court for the Central District of California also lifted a discovery stay to allow plaintiffs to discover the locations of unserved defendants.

Going one step further, in *In re China Valves Technology Securities Litigation*, Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York allowed plaintiffs suing a Chinese-based company to serve defendants through their United States-based lawyers. However, other judges have rejected serving foreign defendants through their U.S.-based attorneys. For example, in *Gearing v. China Agritech, Inc.*, Judge R. Gary Klausner of the U.S. District Court for the Central District of California denied a request by plaintiffs to serve the defendant through local counsel, noting that the plaintiffs had not attempted to serve the defendants through the Hague Convention procedures and "Plaintiffs ha[d] not shown that defendants [we]re evading service or ha[d] refused service." Judge Real in *Stanger* also denied the plaintiffs' request to effect service on foreign defendants through the company's U.S.-based counsel or agent.

PSLRA LEAD PLAINTIFF

In re Smith Barney Transfer Agent Litig., No. 05 Civ. 7583 (WHP) (S.D.N.Y. Dec. 15, 2011)

Click here to view the opinion.

S.D.N.Y. Appoints New Lead Plaintiff After Withdrawal of Original Lead Plaintiff

In a putative securities fraud class action, Judge William H. Pauley of the U.S. District Court for the Southern District of New York appointed a new lead plaintiff and lead counsel after the original lead plaintiff withdrew from the action. The original lead plaintiff had withdrawn after it was disclosed, six years after the action began, that it did not own any of the funds at issue. The court denied the original lead counsel's request to add a new lead plaintiff and allowed motions for a new lead plaintiff. The court determined that the plaintiffs who had moved for appointment as lead plaintiff within 60 days of the original notice had priority over the plaintiffs who had not so moved, and that one proposed plaintiff was the presumptive lead plaintiff because he had a greater financial interest in the action than other plaintiffs who had originally moved for appointment. Although the proposed new lead plaintiff purchased his shares through a dividend reinvestment fund, he satisfied the typicality and adequacy requirements because he purchased shares during the purported class period and his interests were aligned with other members of the purported class.

SCIENTER

Pope Invs. II LLC v. Deheng Law Firm, No. 10 Civ. 6608 (LLS) (S.D.N.Y. Nov. 18, 2011)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims in Connection With Allegedly Embezzled Funds in Chinese Acquisition

Judge Louis L. Stanton of the U.S. District Court for the Southern District of New York dismissed claims that various professionals and firms that advised the plaintiffs in their attempt to acquire a Chinese company violated Section 10(b) of the Securities Exchange Act, because the plaintiffs did not adequately plead scienter. The plaintiffs attempted to acquire a Chinese medical distribution company, but their funds were allegedly embezzled by the owner of a Chinese investment vehicle used to facilitate the acquisition. The plaintiffs did not identify any reports or statements that would have put the defendants on notice that the invested funds would be embezzled, and the plaintiffs' allegations that the defendants benefited from the transaction by collecting professional fees were insufficient to establish motive as a matter of law.

SEC ENFORCEMENT

Sec. & Exch. Comm'n v. Whittemore, No. 10-5321 (D.C. Cir. Oct. 28, 2011)

Click here to view the opinion.

District of Columbia Circuit Upholds Joint and Several Liability for Disgorgement Award in 'Pump and Dump' Scheme

In an SEC enforcement action, the U.S. Court of Appeals for the District of Columbia Circuit upheld a disgorgement award and the imposition of joint and several liability on all defendants in a "pump and dump" scheme. The court followed other circuits in allowing joint and several liability for disgorgement awards without proof of a close relationship among the defendants beyond their participation in a scheme to defraud investors. In addition, the district court did not err in refusing to account for the pre-fraud value of the fraudulently inflated shares because the SEC presented adequate evidence that there was no reliable pre-fraud market value, and the defendant — who asserted his Fifth Amendment right against self-incrimination — did not present any evidence to rebut the SEC's showing.

Sec. & Exch. Comm'n v. Citigroup Global Mkts. Inc., No. 11 Civ. 7387 (JSR) (S.D.N.Y. Nov. 28, 2011)

Click here to view the opinion.

S.D.N.Y. Refuses to Approve Consent Judgment Agreed Upon by the SEC and Citigroup

Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York refused to approve a proposed consent judgment agreed upon by the SEC and Citigroup, because it was not reasonable, fair or adequate, and it did not serve the public interest. The SEC's complaint alleged that Citigroup misrepresented that a fund contained investments selected by an independent adviser when in fact Citigroup had allegedly chosen assets it considered bad investments and taken a short position against those assets. The court ruled that it was required to exercise its independent judgment in determining whether the consent judgment would serve the public interest, because the consent judgment included injunctive relief. However, the consent judgment did not contain any admission of wrongdoing by Citigroup, and so the court had no basis for determining whether the consent judgment was reasonable, fair and adequate, and whether the requested injunctions would serve the public interest. The SEC has appealed this decision to the U.S. Court of Appeals for the Second Circuit.

Sec. & Exch. Comm'n v. Rajaratnam, No. 09 Civ. 8811 (JSR) (S.D.N.Y. Nov. 8, 2011)

Click here to view the opinion.

S.D.N.Y. Determines Rajaratnam's Actions Merit Penalty of Three Times the Profit Gained

Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York assessed civil fines of almost $93 million of Raj Rajaratnam in connection with the Galleon insider trading

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scheme. In determining that Rajaratnam's actions merited a penalty of three times the profit gained, the maximum penalty allowed under the securities laws, the court considered (1) the egregiousness of his conduct, (2) Rajaratnam's scienter, (3) whether his actions created substantial losses or the risk of substantial losses to others, (4) whether Rajaratnam's conduct was recurring, and (5) whether to reduce the penalty because of his current financial condition. The court also refused to reduce Rajaratnam's penalty in light of the fines imposed in his criminal case, because SEC civil penalties are designed to make unlawful trading a "money-losing proposition" both for the current defendant and for those who might consider similar schemes.

Sec. & Exch. Comm'n v. Razmilovic, No. CV-04-2276 (SJF) (WDW) (E.D.N.Y. Sept. 30, 2011)

Click here to view the opinion.

E.D.N.Y. Orders Former Officer to Disgorge Gains of More Than $41 Million

In an SEC enforcement action, Judge Sandra J. Feuerstein of the U.S. District Court for the Eastern District of New York ordered a former COO and CEO to disgorge ill-gotten gains of more than $41 million and pay a civil penalty of more than $20 million following a bench trial. The court ordered the disgorgement of all bonuses the officer had received and the difference between his salaries as COO and CEO because the company's fraudulently inflated financial performance had led to the officer's appointment as CEO. In addition, the officer was required to disgorge the difference between the amount he actually realized from the exercise of his stock options and the amount he would have realized absent his fraud, *i.e.*, the amount he gained from his fraud. The court also ordered him to pay civil penalties of more than $20 million because the officer had fled to Sweden, refused to appear in court, and showed no remorse for his actions.

SECURITIES ACT CLAIMS

City of Roseville Emps.' Ret. Sys. v. EnergySolutions, Inc., No. 09 Civ. 8633 (JGK) (S.D.N.Y. Sept. 30, 2011)

Click here to view the opinion.

S.D.N.Y. Upholds Claims Against Nuclear Industry Engineering Services Provider

Judge John G. Koeltl of the U.S. District Court for the Southern District of New York upheld claims that EnergySolutions violated Sections 11 and 12(a)(2) of the Securities Act by allegedly omitting disclosures required by Item 503 (which requires a discussion of significant risk factors) and Item 103 (which requires a discussion of pending litigation) of Regulation S-K. EnergySolutions, which provided engineering services to the nuclear industry, stated in its registration statements that it had contracts to dispose of "substantially all" of a certain type of nuclear waste with various power plants, but the plaintiffs adequately alleged that most of this type of nuclear waste was either outside the contracts' scope or would only be disposed of far in the future. In addition, EnergySolutions did not disclose that it allegedly knew that its petition for a beneficial rule change would likely be denied because the regulatory agency had previously rejected the same proposal. Finally, EnergySolutions was required to disclose its petition as a pending legal proceeding, and the plaintiffs adequately alleged that it did not disclose all material facts.

SECURITIES FRAUD PLEADING STANDARDS

Granata v. Berson, No. 11 Civ. 689 (KBF) (KNF) (S.D.N.Y. Dec. 5, 2011)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Against Investment Fund and Manager

Judge Katherine B. Forrest of the U.S. District Court for the Southern District of New York dismissed claims that an investment fund and an investment manager violated Section 10(b) of the Securities Exchange Act because they did not make any statements to the plaintiff. The plaintiff alleged that her accountant made false statements while advising her to invest in the defendants' investment fund. However, the complaint did not allege any facts showing that the accountant's statements could be attributed to the investment fund or the investment manager.

Sec. & Exch. Comm'n v. Landberg, No. 11 Civ. 0404 (PKC) (S.D.N.Y. Oct. 26, 2011)

Click here to view the opinion.

S.D.N.Y. Upholds Claims Against CFO for Concealing Investment Companies' Losses

In an SEC enforcement action, Judge P. Kevin Castel of the U.S. District Court for the Southern District of New York upheld SEC claims that the CFO of three investment companies violated Section 10(b) of the Securities Exchange Act, Section 17(a) of the Securities Act, and Sections 206(1), 206(2) and 206(4) of the Investment Advisers Act by allegedly concealing the investment companies' losses. The SEC's claims were not barred by *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (even assuming *Janus* applied to SEC enforcement actions), because the SEC adequately alleged that certain misleading statements were implicitly attributed to the CFO, and it alleged violations beyond the making of misleading statements, which provided an additional basis to support the SEC's fraud claims that did not implicate *Janus*. Further, the SEC's allegations that the CFO distributed inaccurate financial reports, participated in allegedly fraudulent transactions and used "unnecessary accounting maneuvers" to disguise the transactions were sufficient to show that the officer intended to hide the alleged fraud or ignored obvious signs of fraud, and were sufficient to establish scienter.

SLUSA

Brown v. Calamos, No. 11-1785 (7th Cir. Nov. 10, 2011)

Click here to view the opinion.

Seventh Circuit Affirms Dismissal With Prejudice of State Law Breach of Fiduciary Duty Action Preempted by SLUSA

The U.S. Court of Appeals for the Seventh Circuit upheld the dismissal with prejudice of an action on the basis that SLUSA preempted investors' state law breach of fiduciary duty claims related to investment fund stock that lost value in the 2008 financial crisis. The plaintiff brought the suit on behalf of a putative class of owners of Calamos Convertible Opportunities and Income Fund common stock, alleging that the fund represented that investors would benefit from the "indefinite" investment leverage provided by auction market preferred shares (AMPS) issued by the fund, but that the fund redeemed the AMPS following the auction market's 2008 collapse in order to curry favor with investment banks at the expense of stockholders. The complaint further contained a disclaimer stating that the plaintiff asserted no securities fraud claims, but rather only state law claims for breach of fiduciary duty. The defendants removed the action to federal court under SLUSA and moved to dismiss. The district court granted the motion and held that, despite the disclaimer, the complaint alleged the misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security and thus was barred by SLUSA.

On appeal, the Seventh Circuit confronted circuit splits regarding (1) when an action is removable to federal court under SLUSA, and (2) whether a district court may dismiss a lawsuit barred by SLUSA with prejudice, or whether it must remand the action and provide the plaintiff with an opportunity to amend. On the first issue, the court did not expressly adopt the approach of any of its sister circuits, and instead held that SLUSA barred the suit "under any reasonable standard" because the allegations of fraud would be "difficult and maybe impossible to disentangle" from the claims for breach of fiduciary duty. The disclaimer in the complaint had no effect because the plaintiffs' allegations of fiduciary breach were dependent upon allegations of fraud.

The Seventh Circuit agreed, however, with the Sixth Circuit that a court may dismiss with prejudice a suit barred by SLUSA. The Seventh Circuit reasoned that a plaintiff who re-filed a second suit without allegations of fraud might be allowed by the state court to reinsert such allegations at a later point in the litigation. Although defendants then could remove the suit to federal court and move to dismiss again, this approach not only would unreasonably increase the cost and length of litigation, but also would thwart SLUSA's goal of preventing an end-run around the limitations imposed by the Private Securities Litigation Reform Act.

In re Herald, Primeo & Thema Sec. Litig., No. 09 Civ. 289 (RMB) (S.D.N.Y. Nov. 29, 2011)

Click here to view the opinion.

S.D.N.Y. Dismisses Common-Law Claims Against Banks in Litigation Arising From Madoff's Ponzi Scheme

In litigation arising from Bernard Madoff's Ponzi scheme, Judge Richard M. Berman of the U.S. District Court for the Southern District of New York dismissed common-law claims asserted on behalf of a putative class against J.P. Morgan and Bank of New York Mellon, because those claims were precluded by SLUSA. The plaintiffs alleged that the banks committed common-law fraud and aided and abetted common-law fraud, breaches of fiduciary duties, conversion and civil conspiracy in their alleged roles as feeder funds for Madoff. The claims arose in connection with securities because Madoff purported to purchase covered securities, and the plaintiffs' claims against the banks sounded in fraud; consequently, the court held that SLUSA preclusion applied to bar the claims. In addition, although the transactions did not take place in the United States, the court declined to apply *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), to bar SLUSA's application because SLUSA applies to class actions in any U.S. court — state or federal — making the logic of *Morrison* inapplicable. The court also determined that the plaintiffs' claims were preempted by New York's Martin Act, but that determination subsequently was overruled by *Assured Guaranty (UK) Ltd., v. J.P. Morgan Investment Management, Inc.*, 2011 WL 6338898 (N.Y. 2011) (to be published in N.E.2d), which held that the Martin Act does not preclude private common-law causes of action.

STATUTES OF LIMITATIONS AND REPOSE

Strategic Diversity, Inc. v. Alchemix Corp., No. 10-15256 (9th Cir. Dec. 2, 2011)

Click here to view the opinion.

Ninth Circuit Court of Appeals Revives Securities Fraud Suit

The U.S. Court of Appeals for the Ninth Circuit reversed the district court's grant of summary judgment in favor of the defendants on the plaintiffs' state and federal securities claims. The plaintiffs alleged that the defendants made material misrepresentations regarding the certainty and availability of capital from a lender to the company. The district court dismissed the suit, holding the plaintiffs claims were time barred and the plaintiffs failed to show damages. Addressing the statute of limitations issue, the court remanded to the district court for consideration of *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784 (2010). The Ninth Circuit explained that in *Merck*, the Supreme Court held that "the discovery of facts that put a plaintiff on inquiry notice does not automatically begin the running of the limitations period." Moreover, "the ultimate burden is on the defendant to demonstrate that a reasonably diligent plaintiff would have *discovered* the facts constituting the violation." Noting that the defendant "has not met his burden of showing that the claims are time barred" in the instant case, the Ninth Circuit remanded to the district court.

Addressing the damages issues, the court held that a plaintiff suing under Section 10(b) of the Securities Exchange Act is entitled to seek a rescissionary measure of damages. However, a plaintiff seeking rescission must demonstrate economic loss that was caused by the misrepresentation or fraudulent conduct. The Ninth Circuit reversed and remanded because the district court failed to consider a rescissionary measure of damages.

McCann v. Hy-Vee, Inc., No. 11-1459 (7th Cir. Nov. 22, 2011)

Click here to view the opinion.

Seventh Circuit Holds That Statutory Deadline for Filing Securities Suits Runs From the Time of Fraud, Not From the Time of Injury

The Seventh Circuit held that 28 U.S.C. § 1658(b)(2), which provides statutory deadlines for filing federal securities fraud suits, should be treated as a statute of repose rather than as a statue of limitations. Section 1658(b)(2) gives plaintiffs five years to bring suit, with the time period running from the time of the violation, rather than the time of discovery. The plaintiff alleged that Hy-Vee made misrepresentations to her after she received her husband's shares of

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the company's stock as part of a divorce decree. The alleged misrepresentations took place in 2002, but the plaintiff learned of the misrepresentations only when her ex-husband sold the stock in 2007. McCann sued 27 months later, alleging that Hy-Vee violated Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5. The district court held that the claim exceeded the five-year time limit imposed by Section 1658(b)(2) and dismissed the action with prejudice.

The key issue on appeal was whether a "violation" occurs at the time of the fraud (regardless of the time at which a plaintiff suffers a loss) or at the time of the loss caused by the fraud. In other words, the issue turned on whether Section 1658(b)(2) acts as a statute of repose or statute of limitations. The Seventh Circuit determined that Section 1658(b)(2) acted as a statute of repose and affirmed the dismissal. The appeals court reasoned that if injury was an element of a "violation" under Section 1658(b)(2), and thus the statute was a statute of limitations, then a person who bought a security and later discovered the fraud could wait indefinitely to see if the purchase had been a mistake (because of the fraud) or a windfall (because despite the fraud the price of the security had risen beyond expectations). The Seventh Circuit determined that the law would not countenance such a "heads I win, tails you lose" proposition and thus that Section 1658(b)(2) is a statute of repose.

Plumbers' & Pipefitters' Local #562 Supplemental Plan & Trust v. J.P. Morgan Acceptance Corp. I, No. 08 CV 1713 (ERK) (WDW) (E.D.N.Y. Dec. 13, 2011)

Click here to view the opinion.

E.D.N.Y. Allows Nonparty Investors to Intervene as Named Plaintiffs in Putative Securities Class Action

In an opinion marked "not for publication," Judge Edward R. Korman of the U.S. District Court for the Eastern District of New York allowed nonparty investors to intervene as named plaintiffs in a putative securities class action alleging that J.P. Morgan violated Sections 11 and 12(a)(2) of the Securities Act. The investors moved to intervene in an attempt to cure the lead plaintiff's standing deficiencies with respect to certain securities. The intervenors' claims were not barred by the Securities Act's one-year statute of limitations because they related back to the lead plaintiff's surviving claims, tolling the limitations period under *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974). However, the Second Circuit had not determined if *American Pipe* tolling applied to the statute of repose. Instead, the court followed *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000), and concluded that the statute of repose did not bar the intervenors' claims, because the original class action had been filed within the three-year period.

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