

# SECURITIES LITIGATION & REGULATION

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## EXPERT ANALYSIS

### **Beyond Halliburton: Securities Fraud Class-Action Appeals to Watch**

By William H. Gussman, Jr., Esq., and Brian Burns, Esq.  
*Schulte Roth & Zabel*

The U.S. Supreme Court's much-anticipated decision in *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014), declined to jettison the "fraud on the market" presumption of reliance in securities fraud class actions. That decision perhaps was not the watershed ruling that some in the securities litigation defense bar had desired. Still, the decision makes clear that defendants can now rebut the presumption at the class certification stage with evidence that the alleged misrepresentations did not impact the price of the stock.

The implications of that ruling for both plaintiffs and defendants undoubtedly will play out in the lower courts — most immediately in the *Halliburton* case itself, as it returns to the trial court in Texas.

In the meantime, other securities law cases pending in the Supreme Court and the federal courts of appeals merit close attention. This term, the Supreme Court will address the standard for alleging a false statement of opinion or belief in Securities Act cases. Federal courts of appeals are poised to address other important securities fraud class-action issues:

- Issues relating to the other presumption of reliance in securities fraud cases, based on *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).
- The application of the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders*, 131 S. Ct. 2296 (2011), to corporate insiders.
- Issues relating to alleged fraud in connection with risk and internal control system failures.

#### **WHEN IS A STATEMENT OF OPINION OR BELIEF 'FALSE'?**

In late 2005, Omnicare Inc., a large provider of pharmaceutical care services, said, in a registration statement filed in connection with a public stock offering, that it believed certain arrangements it had with health care providers and pharmaceutical companies complied with applicable federal and state laws. According to the plaintiffs, however, the arrangements were unlawful kickback schemes.

The plaintiffs sued under Section 11 of the Securities Act, based on the allegedly false statements in the registration statement. The defendants then moved to dismiss, arguing that the plaintiffs had not adequately alleged that those statements, which reflected Omnicare's opinion or belief, were "false."

The issue passed before the 6th U.S. Circuit Court of Appeals and is now before the Supreme Court, in *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund*, No. 13-435. The



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question is whether, in order to allege a “false” statement of opinion or belief under Section 11 (which does not require a showing of *scienter*), a plaintiff must plead that the statement was both objectively false and subjectively false.

In other words, is it enough for the plaintiff to plead that the statement turned out to be incorrect (objectively false), or must the plaintiff also plead that the speaker did not believe the statement when it was made (subjectively false)? The 6th Circuit held that objective falsity was enough, creating a circuit split with the 2nd and 9th circuits.<sup>1</sup>

The Supreme Court's decision is likely to turn largely on the meaning of an earlier high court decision, *Virginia Bankshares Inc. v. Sandberg*, 501 U.S. 1083 (1991). That case involved a claim under Section 14(a) of the Securities Exchange Act for allegedly misleading statements in a proxy. The Supreme Court held that a statement of reasons, opinion or belief — there, a statement that the directors of a company believed a merger offered a “high value” — could be actionable as a material misstatement when it misstated the speaker's true opinion or belief and also misled about the underlying subject matter. The parties in *Omnicare* dispute the extent to which *Virginia Bankshares* required subjective falsity.

The parties also dispute the extent to which a statement of opinion or belief can be considered “factual.” According to *Omnicare*, the only “fact” conveyed by a statement of opinion or belief is the fact that the speaker held the stated belief.

The plaintiffs, on the other hand, contend that a statement of opinion can also be false or misleading about the underlying subject matter or the speaker's basis for holding the opinion. In an amicus brief, the United States argues that even genuinely held opinions should be actionable if they lack a reasonable basis.

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### THE OTHER PRESUMPTION OF RELIANCE

The other presumption of reliance in securities fraud cases is used in “omission” cases and based on the Supreme Court's decision in *Affiliated Ute Citizens of Utah v. United States*. With the fraud-on-the-market presumption of reliance still standing, though, the *Affiliated Ute* presumption may not overshadow the fraud-on-the-market presumption anytime soon. Nonetheless, important questions remain unanswered with respect to this presumption, and in a case arising from the May 2012 Facebook IPO, the Nasdaq stock exchange is asking the 2nd Circuit to clarify its applicability.

The plaintiffs in *In re Facebook Inc. IPO Securities and Derivative Litigation*, No. 14-457 (2d Cir.) — individuals and entities that placed orders to buy or sell Facebook stock on the day of the IPO — sued Nasdaq for securities fraud. They alleged violations of Section 10(b) and Rule 10b-5, pointing to statements Nasdaq had made before the class period about the quality and capacity of its trading systems.

According to the plaintiffs, those statements became false or misleading when, in the period leading up to the Facebook IPO, Nasdaq became aware, but failed to disclose, that its systems were flawed and inadequate to handle the IPO. The plaintiffs' hook to allege reliance was the presumption articulated in *Affiliated Ute*.

The *Affiliated Ute* presumption of reliance applies in cases where “there is an omission of a material fact by one with a duty to disclose.”<sup>2</sup> The presumption is designed to address situations in which “no positive statements exist,” and reliance, therefore, “as a practical matter is impossible to prove.”<sup>3</sup>

To establish the “duty” element necessary to invoke the presumption, the *Facebook* plaintiffs argued that Nasdaq had a duty to update its prior statements when it allegedly learned that its trading systems were not as robust as its pre-class-period statements suggested. The District Court agreed with the plaintiffs and applied the presumption.<sup>4</sup>

Nasdaq is now asking the 2nd Circuit to review the District Court's application of *Affiliated Ute*. But whether the court will do so is, at this point, an open question. The District Court refused to

certify its decision for interlocutory appeal, but Nasdaq, nonetheless, took an immediate appeal because the District Court, in part, denied its claim of self-regulatory organization immunity. In its brief before the 2nd Circuit, Nasdaq asks the court to exercise pendent jurisdiction to review the *Affiliated Ute* issue.

Assuming the 2nd Circuit accepts the invitation, the result could be important. According to Nasdaq, any attempt to rely on the duty to update prior statements as the hook for invoking *Affiliated Ute* is foreclosed by the 2nd Circuit's decision in *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 93 (2d Cir. 1981).

In that case, an investor alleged a company executive's statements about possible future earnings were rendered misleading by the company's actual performance. When the plaintiff tried to invoke the *Affiliated Ute* presumption by focusing on the company's omission of its actual financial results, the 2nd Circuit rejected the argument because the plaintiff's case was not one in which "no positive statements exist."

As the court recognized, nearly every misstatement case can be recast as an omission case by alleging that the defendant omitted the truth. If that was all it took to invoke *Affiliated Ute*, however, the presumption would effectively eviscerate the reliance requirement.

Under that logic, it is easy enough to say that anytime a case involves affirmative statements that can be characterized as misleading in some way, *Affiliated Ute* is inapplicable. But that is not precisely how district courts in the 2nd Circuit have applied it.

Instead, the district courts have relied, in part, on the language in *Affiliated Ute* itself that the presumption applies in cases involving "primarily a failure to disclose."<sup>5</sup> With that starting point, district courts have looked at whether the alleged omission is simply the "flip side" or "inverse" of the affirmative statement, or whether the omission goes beyond the affirmative statement.

For example, where an issuer said it followed certain underwriting standards but failed to disclose that it, in fact, materially disregarded those standards, the "omission" was simply the "flip side" of the affirmative statement, and the presumption was inapplicable.<sup>6</sup>

In another case, a defendant said it set up an in-house transfer agent and hired its former agent as a sub-transfer agent, but allegedly failed to disclose that it was pocketing the arrangement's cost-savings at the investors' expense. There, the presumption of reliance did apply.<sup>7</sup>

As the cases suggest, the line where a case becomes "primarily" about omissions is not always an easy one to draw, and a new 2nd Circuit decision on this issue could provide useful guidance. The parties in *Facebook* are still briefing the issues, and oral argument has not yet been scheduled.

## DOES JANUS APPLY TO CORPORATE INSIDERS?

In *Janus Capital Group v. First Derivative Traders*, the Supreme Court held that for purposes of a claim under Section 10(b) and Rule 10b-5, the "maker" of a statement is the person with "ultimate authority" over that statement. In *Glickenhau Institutional Group v. Household International Inc.*, No. 13-3532 (7th Cir.), a 12-year-old class action on appeal following a jury trial, the defendants are asking the 7th Circuit to rule that *Janus* applies to corporate insiders' statements.

In *Glickenhau*, the plaintiffs alleged that Household International, a consumer finance company, committed securities fraud by, among other things, falsely denying its involvement in predatory lending practices. When the case went to trial (prior to *Janus*), the District Court provided a jury instruction on what it meant to make a misrepresentation.

That instruction directed the jury to assess whether a defendant "made, approved or furnished information to be included in a false statement of fact." The defendants objected to the instruction at the time, but the court delivered it anyway, and the jury returned a verdict in favor of the plaintiffs, finding that the defendants had committed securities fraud in connection with 17 misstatements.

After *Janus* was decided, Household International moved for a new trial, arguing, among other things, that *Janus* made clear that the prior jury instruction was improper. The District Court

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rejected the argument, finding *Janus* inapplicable because *Janus* involved the liability of a “third-party entity” (i.e., the potential liability of a mutual fund investment adviser for statements in the mutual fund’s prospectus). *Glickenhau*s, however, concerned the liability of corporate insiders.

On appeal now, the defendants are challenging that conclusion, arguing that nothing in *Janus* limits its applicability to situations involving “third-party entities.” The rationale behind *Janus*, according to the defendants, was to draw a clean line between primary liability (for which defendants can be held liable in private actions) and secondary liability (for which they cannot). The defendants say this rationale applies equally when the defendants are corporate insiders, as a number of district courts have held.<sup>8</sup>

In addition to the *Janus* issue, the appeal presents issues relating to whether the plaintiffs properly proved loss causation and whether the District Court improperly limited the defendants’ ability to rebut the fraud-on-the-market presumption of reliance. The appeal has been fully briefed, and the 7th Circuit heard oral argument May 29.

### ROGUE TRADERS AND RISK CONTROLS

When a company reveals that its risk and internal control systems failed to catch wrongdoing — for example, a bank failing to catch a rogue trader — plaintiffs often bring securities fraud complaints contending that the bank knew its systems were flawed. This occurred in *C.D.T.S. No. 1 v. UBS AG*, No. 12 Civ. 4924, 2013 WL 6576031 (S.D.N.Y. Dec. 13, 2013), where the plaintiffs brought securities fraud claims after UBS revealed it had lost over \$2 billion because of unauthorized trading by Kweku Adoboli, a former director of UBS.

As the District Court noted, however, courts “often dismiss” such claims.<sup>9</sup> The court did just that, and the plaintiffs are now asking the 2nd Circuit to revive their claims in *C.D.T.S. No. 1 v. UBS AG*, No. 14-165 (2d Cir.).

The plaintiffs contended that during the class period, UBS’ risk controls were inadequate because the bank allegedly failed to document and properly monitor certain risk characteristics. According to the plaintiffs, this rendered false and misleading statements like the UBS CEO’s assertion that “we know what kind of risks we have.” The District Court found UBS’ statements about its risk controls to be inactionable “puffery,” meaning they were too vague and general to be material.

Just weeks before the plaintiffs filed their opening brief on appeal, the 2nd Circuit decided *City of Pontiac Policemen’s and Firemen’s Retirement System v. UBS AG*, 752 F.3d 173 (2d Cir. May 6, 2014). The court’s opinion is most notable for holding that investors who purchase shares of a foreign issuer on a foreign exchange cannot bring claims under the Securities Exchange Act, even if the shares are cross-listed on a domestic exchange. The court also held, however, that certain other statements made by UBS were inactionable puffery because they were “aspirational, with qualifiers such as ‘aims to,’ ‘wants to’ and ‘should.’”<sup>10</sup>

The plaintiffs in *C.D.T.S.* are arguing that their case is different, because UBS’ statements were phrased as facts, and not as goals or aspirations. The plaintiffs also argue that the statements were made in response to specific questions from analysts, thus suggesting that investors considered the subject matter material.

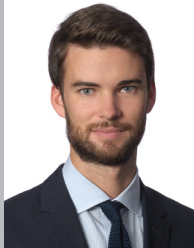
This case gives the 2nd Circuit another chance to weigh in on securities fraud actions arising from risk control failures and to potentially address the line separating inactionable puffery from material affirmative statements. The appeal is now fully briefed, but oral argument has not been scheduled.

### CONCLUSION

With the Supreme Court’s *Halliburton* decision in the rearview mirror, other important securities law class-action issues remain on appeal at the Supreme Court and federal appellate levels. Their resolutions are likely to shape how parties will approach their securities class-action litigation strategies in the years to come.

## NOTES

- <sup>1</sup> See *Ind. State Dist. Council of Laborers v. Omnicare Inc.*, 719 F.3d 498 (6th Cir. 2013); *Fait v. Regions Fin. Corp.*, 655 F.3d 105 (2d Cir. 2011); *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156 (9th Cir. 2009).
- <sup>2</sup> *Stoneridge Inv. Partners LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148, 159 (2008).
- <sup>3</sup> *Wilson v. Comtech Telecomms. Corp.*, 648 F.2d 88, 93 (2d Cir. 1981).
- <sup>4</sup> See *In re Facebook Inc. IPO Sec. & Derivative Litig.*, 986 F. Supp. 2d 428, 469-70, 484-86 (S.D.N.Y. 2013).
- <sup>5</sup> 406 U.S. at 153 (emphasis added).
- <sup>6</sup> See *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.*, No. 05-cv-1898, 2006 WL 2161887, at \*9 (S.D.N.Y. Aug. 1, 2006), *aff'd*, 546 F.3d 196 (2d Cir. 2008).
- <sup>7</sup> See *In re Smith Barney Transfer Agent Litig.*, 290 F.R.D. 42, 47-48 (S.D.N.Y. 2013).
- <sup>8</sup> See, e.g., *In re UBS AG Sec. Litig.*, No. 07-11225, 2012 WL 4471265, \*10 (S.D.N.Y. Sept. 28, 2012); *Haw. Ironworkers Annuity Trust Fund v. Cole*, No. 10-371, 2011 WL 3862206, at \*4 (N.D. Ohio Sept. 7, 2011).
- <sup>9</sup> *C.D.T.S. No. 1 v. UBS AG*, No. 12 Civ. 4924, 2013 WL 6576031, at \*6 (S.D.N.Y. Dec. 13, 2013).
- <sup>10</sup> *City of Pontiac*, 752 F.3d at 183.



**William H. Gussman, Jr.** (L) is a partner with **Schulte Roth & Zabel** in New York, where his practice focuses on representing financial institutions, officers and directors in complex commercial litigation, including securities fraud and fraudulent transfer actions, M&A litigation, private post-acquisition disputes, and derivative actions. He frequently tries cases in federal and state courts throughout the United States and represents clients in a variety of alternative dispute resolution venues, as well as in bankruptcy court and in connection with SEC investigations. He can be reached at [bill.gussman@srz.com](mailto:bill.gussman@srz.com). **Brian Burns** (R) is a litigation associate with Schulte Roth & Zabel, where he assists clients with securities litigation and investigations, including insider trading matters. He also has experience serving as a law clerk to two federal judges in the Southern District of New York.