SIMPSON THACHER
SECURITIES LAW ALERT
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This month's edition addresses two Supreme Court decisions handed down in June: *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014) (Roberts, C.J.), in which the Court adopted a middle ground in the challenge to the fraud-on-the-market presumption of reliance established in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (Blackmun, J.); and *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014) (Breyer, J.), in which the Court clarified the requirements for pleading an Employee Retirement Income Security Act (ERISA) breach of the duty of prudence claim involving an Employee Stock Ownership Plan (ESOP).

In addition, we discuss three Second Circuit opinions: one holding that funding an ESOP with company stock rather than cash does not constitute fiduciary conduct for ERISA purposes; another vacating Judge Rakoff's decision denying approval of the SEC's consent decree with Citigroup; and a third dismissing for lack of standing a challenge by non-settling defendants PricewaterhouseCoopers and Citco to a settlement of certain Madoff-related putative class action claims.

Finally, we address a Fifth Circuit decision reviving a securities fraud action against Houston American Energy Corporation, and a Ninth Circuit decision affirming dismissal of a securities fraud action against Intuitive Surgical.

Supreme Court Adopts Middle Ground in Challenge to *Basic*'s Fraud-on-the-Market Presumption of Reliance

On June 23, 2014, the Supreme Court held that investors may continue to invoke a rebuttable presumption that they relied on an alleged misrepresentation when they purchased securities in an efficient market. *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014) (Roberts, C.J.). However, the Court also ruled that defendants may rebut the presumption of reliance at the class certification stage by showing the alleged misrepresentation did not actually impact the stock price. The Supreme Court's "middle ground" approach will likely result in district courts conducting more evidentiary hearings at the class certification stage, with district court judges carefully evaluating the evidence of price impact (or lack thereof) and declining to certify those cases where the court finds the alleged misrepresentation did not distort the market price of the stock.

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The Fraud-on-the-Market Presumption

Investors can recover damages in a private securities fraud action only if they prove that they relied on the defendant's misrepresentation in deciding to buy or sell a company's stock. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (Blackmun, J.), a plurality of the Supreme Court held that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would" prevent securities fraud plaintiffs "from proceeding with a class action, since individual issues" of reliance would "overwhelm[ ] the common ones." The *Basic* Court thus endorsed a "fraud-on-the market" theory, which permits securities fraud plaintiffs to invoke a rebuttable presumption of reliance on public, material misrepresentations regarding securities traded in an efficient market. However, the *Basic* Court ruled that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance."

The fraud-on-the-market theory endorsed by the *Basic* Court has two constituent premises. First, "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." Second, "most publicly available information is reflected in [the] market price [of a security]." In endorsing the theory, the Court cited empirical studies that "tended to confirm" that the "market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."

Recently, in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S. Ct. 1184 (2013) (Ginsburg, J.),[1] where the Court held that plaintiffs do not have to prove materiality to invoke the presumption, four Justices voiced reservations concerning the continued viability of *Basic*'s fraud-on-the-market presumption. Justice Alito, concurring, observed that "recent evidence suggests that the [fraud-on-the-market] presumption may rest on a faulty economic premise" and suggested that "reconsideration of the *Basic* presumption may be appropriate." Justice Thomas, dissenting, joined by Justices Kennedy and Scalia, observed that "[t]he *Basic* decision itself is questionable" and noted that the *Basic* dissent's concerns with the economic theories underlying the fraud-on-the-market presumption "remain valid today."

Halliburton asked the Court to overrule *Basic* and require plaintiffs to prove actual reliance. Alternatively, Halliburton asked the Court to afford defendants an opportunity to rebut the presumption of reliance and defeat class certification with evidence that the alleged misrepresentation did not distort the market price of the stock.

Case Background

The underlying litigation in *Halliburton* involves securities fraud claims brought against Halliburton Company and its CEO (collectively, "Halliburton") in connection with alleged misstatements concerning Halliburton's expected revenues, projected liability

1. Please click here to read our discussion of the *Amgen* decision in the March 2013 edition of the Alert.

for asbestos claims, and the anticipated cost savings and efficiencies of a 1998 merger.

This is the second Supreme Court disposition of the case. In 2011, the Supreme Court unanimously held that the Fifth Circuit had "erred by requiring proof of loss causation for class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (Roberts, C.J.) (*Halliburton I*).[2] The Supreme Court remanded the action for consideration of additional arguments in opposition to class certification.

In the district court on remand, Halliburton argued that the class should not be certified because the evidence showed that the alleged misrepresentations did not affect the price of the company's shares. The district court declined to consider this evidence, finding that defendants may not rebut the fraud-on-the-market presumption at the class certification stage by showing an absence of price impact. Halliburton appealed. Relying on the Supreme Court's decision in *Amgen*, 133 S. Ct. 1184, the Fifth Circuit agreed, holding that "price impact fraud-on-the-market rebuttal evidence should not be considered at class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423 (5th Cir. 2013) (Davis, J.).

Summary of the Decision

The Supreme Court unanimously held that defendants must have an opportunity to rebut the *Basic* presumption of reliance at the class certification stage with evidence that the alleged misstatement did not distort the market price of the stock. The Court was divided 6-to-3 on whether to jettison the *Basic* presumption altogether and require that plaintiffs prove actual reliance. Chief Justice Roberts, writing for the majority, concluded that the *Basic* presumption should be preserved. Justices Kennedy, Ginsburg, Breyer, Sotomayor, and Kagan joined the majority opinion. In a concurring opinion joined by Justices Scalia and Alito, Justice Thomas wrote that *Basic* should be overruled entirely.

The Court Declines to Eliminate *Basic*'s Presumption of Reliance

At the outset, the Court observed that Halliburton faced a high standard for overruling *Basic*. "Before overturning a long-settled precedent, however, we require 'special justification,' not just an argument that the precedent was wrongly decided." The Court found that Halliburton had not met that heightened showing.

First, the Court declined Halliburton's invitation to revisit the issue of whether the *Basic* presumption is consistent with Congress' intent in passing the Securities Exchange Act of 1934. "The *Basic* majority did not find that argument persuasive then, and Halliburton has given us no new reason to endorse it now."

Second, the Court rejected Halliburton's argument that the economic theory upon which the *Basic* presumption rests can no longer withstand scrutiny. "The academic debates discussed by Halliburton have not refuted the modest premise underlying the presumption of reliance. Even the foremost critics of the efficient-capital markets hypothesis acknowledge that public information generally affects stock prices … Halliburton has not identified the kind of fundamental shift in economic theory that could justify overruling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities."

Third, the Court dismissed Halliburton's argument that *Basic* is at odds with recent decisions construing the Rule 10b-5 implied right of action and class certification standards. The Court explained that in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (Kennedy, J.) and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) (Kennedy, J.), it was asked to extend Rule 10b-5 to new categories of defendants and that doing so "would have

2. Please click here to read our discussion of the *Halliburton I* decision in the June 2011 edition of the Alert.

eviscerated the requirement that a plaintiff prove that he relied on a misrepresentation made *by the defendant*." The *Basic* presumption, by contrast, "does not eliminate that requirement but rather provides an alternative means of satisfying it." The Court similarly found that *Basic* is consistent with the recent holdings in *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) (Scalia, J.) and *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013) (Scalia, J.) that plaintiffs must prove, not simply plead, that common questions of reliance predominate over individual ones.

Finally, the Court concluded that the policy concerns raised by Halliburton, such as the proliferation of strike suits where plaintiffs leverage class certification to obtain large settlements from defendants, are more properly addressed to Congress.

The Court Holds Defendants Can Rebut the *Basic* Presumption with Evidence That the Alleged Misstatement Did Not Affect the Stock Price

Halliburton proposed two alternatives to overruling *Basic*. The first alternative would require plaintiffs to prove that a defendant's misrepresentation actually affected the stock price in order to invoke the *Basic* presumption. The second proposed alternative would allow defendants to rebut the presumption of reliance with evidence of a lack of price impact before class certification.

The Court declined to put the burden on plaintiffs to prove price impact on the grounds that it would "effectively jettison half of [the *Basic* presumption]." Distinguishing between materiality (a merits inquiry) and price impact (which "has everything to do with the issue of predominance at the class certification stage"), the Court ruled that defendants must be given the opportunity to defeat the presumption at the class certification stage through evidence that an alleged misrepresentation did not actually affect the market price of the stock. The Court observed that in many misrepresentation-based cases the parties already introduce competing price impact evidence at the class certification stage to address the question of whether the market is efficient—a prerequisite for invoking the *Basic* presumption. The Court recognized it would be a "bizarre result[ ]" not to allow such evidence for the purpose of rebutting the *Basic* presumption altogether. "Evidence of price impact will be before the court at the certification stage in any event … [W]e see no reason to artificially limit the inquiry at the certification stage to indirect evidence of price impact."

Because the courts below had denied Halliburton the opportunity to show lack of price impact at the class certification stage, the Court vacated the judgment of the Fifth Circuit and remanded the case for further proceedings consistent with the opinion.

Justice Ginsburg's Concurring Opinion

Justice Ginsburg (joined by Justices Breyer and Sotomayor) penned a very brief concurring opinion to express the view that the Court's decision "should impose no heavy toll on securities-fraud plaintiffs with tenable claims." Justice Ginsburg recognized, however, that "[a]dvancing price impact consideration from the merits stage to the certification stage may broaden the scope of discovery available at certification."

Justice Thomas's Concurring Opinion

Justice Thomas authored an opinion (joined by Justices Scalia and Alito) concurring in the judgment but concluding that *Basic* should be overruled and that plaintiffs should be required to prove actual reliance. "Logic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and *stare decisis* cannot prop up the façade that remains."

The concurrence first attacked the theories underpinning the *Basic* presumption. "The first

assumption—that public statements are 'reflected' in the market price—was grounded in an economic theory that has garnered substantial criticism since *Basic*. The second assumption—that investors categorically rely on the integrity of the market price—is simply wrong."

Second, the concurrence credited Halliburton's argument that the *Basic* presumption conflicts with the Court's more recent cases clarifying Rule 23's class-certification requirements, including the *Wal-Mart* and *Comcast* decisions that hold a party seeking to maintain a class action "must affirmatively demonstrate his compliance with Rule 23."

Third, the concurrence observed that "the realities of class-action procedure make rebuttal based on an individual plaintiff's lack of reliance virtually impossible." That is because at the class certification stage "rebuttal is only directed at the class representatives, which means that counsel only needs to find one class member who can withstand the challenge."

Finally, the concurrence found that principles of *stare decisis* do not dictate the preservation of *Basic*, particularly given the fact that the *Basic* presumption is judge-made law. Nor is it appropriate, the concurrence posited, to "draw from Congress' silence on this matter an inference that Congress approved of *Basic*." "[W]hen we err in areas of judge-made law, we ought to presume that Congress expects us to correct our own mistakes—not the other way around."

Supreme Court Clarifies Pleading Standards for ERISA Breach of Duty of Prudence Claims against ESOP Fiduciaries

On June 25, 2014, the Supreme Court clarified the requirements for pleading an Employee Retirement Income Security Act (ERISA) breach of the duty of prudence claim involving Employee Stock Ownership Plans (ESOPs), employee benefit plans that invest primarily in employer stock. *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014) (Breyer, J.). The Court concluded, in a unanimous opinion, that ESOP fiduciaries are not entitled to a special presumption of prudence. At the same time, however, the Court articulated alternative defenses that defendants can assert in response to ERISA stock drop cases, including, for example, that a complaint fails to plausibly allege a legal alternative action that the defendant could have taken that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm than to help. The Court also held that allegations that defendants should have sold based on publicly available information are generally insufficient to state a claim. Moreover, ERISA does not require a fiduciary to "break the law" by acting on non-public or inside information.

Background

Defendant Fifth Third, a financial services company, sponsored a 401(k) defined contribution plan. Eligible Fifth Third employees were permitted to make voluntary contributions to the plan and direct them to any of the plan's investment options. The plan required that one investment option offered to plan participants be the Fifth Third Stock Fund, which was an ESOP.

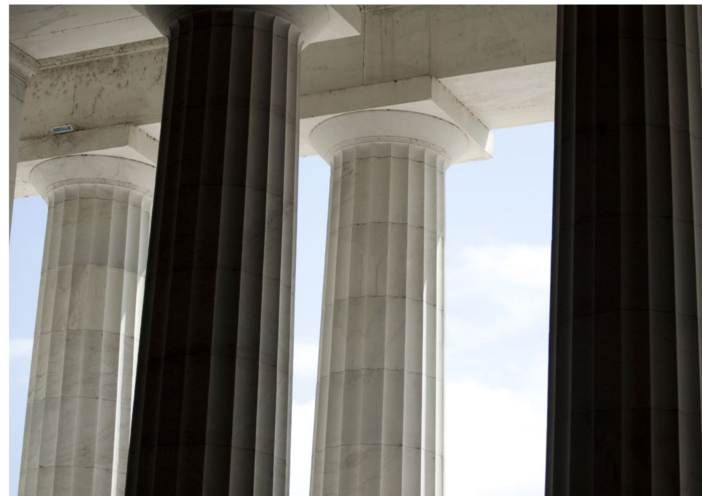
Plaintiffs alleged that Fifth Third and plan

fiduciaries violated their fiduciary duties under ERISA by continuing to offer the Fifth Third Stock Fund after it had purportedly become an imprudent investment. The Southern District of Ohio dismissed the complaint, holding that the fiduciaries were entitled to a presumption of prudence with respect to their decision to include the employer stock fund as an investment option. The district court held that plaintiffs had failed to overcome the presumption because they had not pled facts showing that the company was in a dire financial predicament.

The Sixth Circuit reversed, holding that the presumption of prudence did not apply at the pleading stage. The court held that the presumption was an evidentiary standard and not a standard of review, and would apply at summary judgment. The Sixth Circuit's holding differed from the standards in the Second, Third, Fifth, Seventh, and Eleventh Circuits, all of which have held that the presumption of prudence applies at the pleading stage.

Summary of the Decision

Justice Breyer wrote the opinion for a unanimous Court. In holding that ESOP fiduciaries were not entitled to a special presumption of prudence, the Court looked to the language of ERISA. The Court stated that its conclusion that "the law does not create a special presumption" "follows from the pertinent provisions of ERISA," and cited Section 1104, which discusses the duty of prudence. The Court noted that Section 1104 "establishes the extent to which [the duty of prudence is] loosened in the ESOP context to ensure that employers are permitted and encouraged to offer ESOPs." The Court further explained that Section 1104 "makes no reference to a 'special presumption' in favor of ESOP fiduciaries." Rather, the only modification permitted under ERISA for ESOP fiduciaries is an exemption from ERISA's diversification requirement (i.e. ESOPs can make undiversified investments in employer stock). The Court concluded: "Thus, ESOP



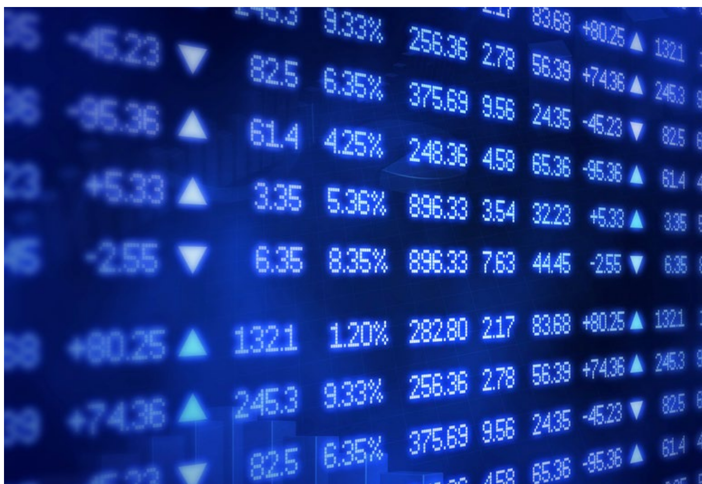
fiduciaries, unlike ERISA fiduciaries generally, are not liable for losses that result from a failure to diversify. But aside from that distinction, because ESOP fiduciaries are ERISA fiduciaries and because §1104(a)(1)(B)'s duty of prudence applies to all ERISA fiduciaries, ESOP fiduciaries are subject to the duty of prudence just as other ERISA fiduciaries are."

The Court then clarified the requirements for pleading an ERISA breach of the duty of prudence claim. The Court noted that the Sixth Circuit had held that plaintiffs-respondents had stated a plausible duty of prudence claim. The Court vacated and remanded the Sixth Circuit's decision to apply the pleading standard as discussed in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) (Souter, J.) and *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009) (Kennedy, J.) in light of the following considerations:

First, the Court held that "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances." The Court held that ERISA fiduciaries who "could reasonably see 'little hope of outperforming the market … based solely on their analysis of publicly available information,' may, as a general matter, [ ] prudently rely on the market price."

Second, "[t]o state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff

must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it."



In conducting this analysis, courts should bear in mind the following: (1) ERISA "does not require a fiduciary to break the law," such as engaging in insider trading by divesting the fund's holdings based on inside information; (2) where a complaint alleges that a fiduciary, based on inside information, should have refrained from making additional stock purchases or disclosed the inside information to the public, courts should "consider the extent to which an ERISA-based obligation" to do so "could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws"; and (3) "whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases—which the market might take as a sign that insider fiduciaries viewed the employer's stock as a bad investment—or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund."

Second Circuit Holds That Funding an ESOP with Company Stock Rather than Cash Does Not Constitute Fiduciary Conduct for ERISA Purposes

On May 29, 2014, the Second Circuit affirmed dismissal of two ERISA actions brought by investors in the Morgan Stanley 401(k) Plan and the Morgan Stanley Employee Stock Ownership Plan (collectively, the "Plans") in connection with Morgan Stanley's election to make company contributions to the Plans in the form of company stock rather than cash in 2006 and 2007. *Coulter v. Morgan Stanley & Co., Inc.*, 2014 WL 2212014 (2d Cir. May 29, 2014) (per curiam) (*Coulter II*). The Second Circuit held that "the challenged conduct, even if it negatively impacted the Plans, did not occur in the performance of a fiduciary function and therefore cannot trigger fiduciary liability under ERISA."

Background

Beginning in December 2007, "after Morgan Stanley's stock price plunged in connection with the broader economic downturn," plaintiffs filed a series of ERISA actions seeking "to recover for losses the Plans suffered as a result of the drop in Morgan Stanley's stock price." Among other defendants, plaintiffs brought suit against Morgan Stanley; Morgan Stanley & Co. Inc.; Morgan Stanley's CEO and Chairman of the Board John Mack; and members of Morgan Stanley & Co.'s Board of Directors (collectively, the "Morgan Stanley Defendants").

The Morgan Stanley Defendants moved to dismiss on the grounds that they were neither named fiduciaries under the Plans nor *de facto* fiduciaries for ERISA purposes. In December 2009, the Southern District of New York denied the Morgan Stanley

Defendants' motion to dismiss the consolidated actions. *In re Morgan Stanley ERISA Litig.*, 696 F. Supp. 2d 345 (S.D.N.Y. 2009) (Sweet, J.). The court found, *inter alia*, that plaintiffs had "alleged sufficient facts to establish, at the pleading stage" that the Morgan Stanley Defendants were *de facto* fiduciaries for ERISA purposes based on allegations that the Morgan Stanley Defendants had "exercised the necessary control over the Plans in determining whether to fund Employer Contributions in Company Stock rather than cash, and by establishing rules regarding the transfer of Company Stock into other forms of investment in the Plans."

Plaintiffs later filed a second action asserting the same claims with respect to a different class period. On March 28, 2013, the Southern District of New York granted defendants' motion to dismiss both actions based on the *Moench* presumption of prudence. *In re Morgan Stanley ERISA Litig.*, 2013 WL 1267551 (S.D.N.Y. Mar. 28, 2013) (Batts, J.); *Coulter v. Morgan Stanley & Co., Inc.*, 936 F. Supp. 2d 306 (S.D.N.Y. 2013) (Batts, J.). However, the court did not reverse its December 2009 ruling holding that the Morgan Stanley Defendants were *de facto* fiduciaries for ERISA purposes. Plaintiffs appealed.

Second Circuit Finds the Morgan Stanley Defendants Were Not Acting as *De Facto* Fiduciaries When They Opted to Fund the Plans with Company Stock Rather than Cash

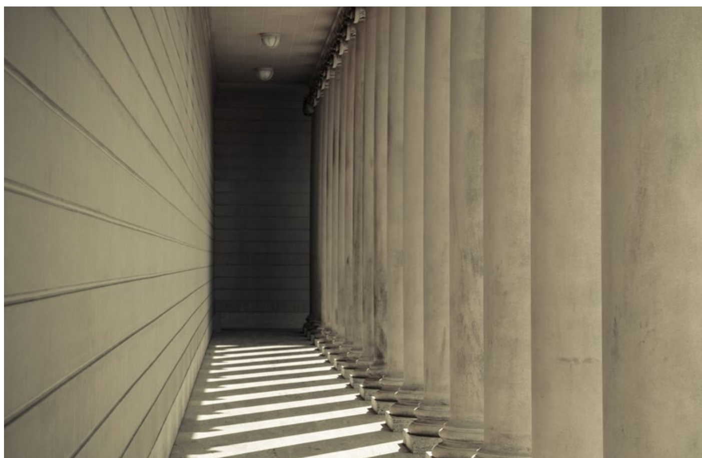
The Second Circuit explained that the "threshold question" in any ERISA action is whether the defendant "was acting as a fiduciary (that is, performing a fiduciary function) when taking the action subject to complaint." Here, the Plans did not name the Morgan Stanley Defendants as fiduciaries. The Second Circuit stated that "[p]laintiffs' claims may therefore lie against" the Morgan Stanley Defendants "only to the extent that [the Morgan Stanley] Defendants, in electing to make Company contributions with Company Stock, acted as *de facto* fiduciaries." The Second Circuit noted that "a person is a *de facto* fiduciary under ERISA 'to the extent' she, *inter alia*, (a) 'exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,' or (b) 'has any discretionary authority or discretionary responsibility in the administration of such plan.'" (quoting 29 U.S.C. §§ 1002(21)(A)).

The Second Circuit determined that even if the Morgan Stanley Defendants "had full authority and discretion to satisfy Company contributions in stock or cash, the exercise of this discretion does not constitute fiduciary conduct under ERISA" because "the discretionary act must be undertaken with respect to plan management or administration." The Second Circuit emphasized the differences between "fiduciary functions, which give rise to ERISA liability, and 'settlor' functions, which are akin to actions taken by the settlor of a trust and do not trigger ERISA liability." "Fiduciary functions include, for instance, 'the common transactions in dealing with a pool of assets: selecting investments, exchanging one instrument or asset for another, and so on." Settlor functions, on the other hand, "include conduct such

as establishing, funding, amending or terminating a plan."

The Second Circuit reasoned that the Morgan Stanley "Defendants' decision to fund Company contributions in Company Stock could not constitute a fiduciary act" for ERISA purposes "because, at the time of the decision, the Company Stock was not a Plan Asset." Moreover, the Second Circuit explained that the Morgan Stanley Defendants "were not fiduciaries because they had 'no authority or responsibility' over either Plan" and "their discretion began and ended with selecting the form of Company contributions." Notably, the Second Circuit found it irrelevant that the Morgan Stanley "Defendants' decision to fund the Plans with Company Stock" may have "negatively impacted the Plans." The court emphasized that "fiduciary status turns on ERISA's plain language and does not exist simply because an employer's business decision proved detrimental to a covered plan or its beneficiaries."

The Second Circuit therefore dismissed plaintiffs' ERISA claims. The court also dismissed plaintiffs' conflict of interest claim against Morgan Stanley's CEO and Chairman of the Board John Mack because "Mack had no fiduciary duty under ERISA to avoid a conflict of interest." In addition, the court dismissed plaintiffs' failure to monitor and breach of co-fiduciary duty claims because those claims "cannot survive absent a viable claim for breach of a duty of prudence."



Second Circuit Vacates Judge Rakoff's Decision Denying Approval of the SEC's Consent Decree with Citigroup

In November 2011, Judge Jed S. Rakoff of the Southern District of New York refused to approve a proposed consent judgment in the SEC's enforcement action against Citigroup Global Markets ("Citigroup") because the terms of the settlement provided that Citigroup neither admitted nor denied the allegations. *U.S. Securities and Exchange Commission v. Citigroup Global Markets Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (Rakoff, J.). (*Citigroup I*).[3] On June 4, 2014, the Second Circuit vacated Judge Rakoff's order. *U.S. Securities and Exchange Commission v. Citigroup Global Markets, Inc.*, 752 F.3d 285 (2d Cir. 2014) (Pooler, J.) (*Citigroup II*). The Second Circuit held that it was an "abuse of discretion to require, as the district court did here, that the [SEC] establish the 'truth' of the allegations against [Citigroup] as a condition for approving the consent decree[ ]."

Background

In October 2011, the SEC brought suit against Citigroup alleging misrepresentations in connection with a billion dollar investment fund Citigroup created. According to the SEC's complaint, Citigroup had claimed that "the [f]und's assets were attractive investments rigorously selected by an independent investment advisor." *Citigroup I*, 827 F. Supp. 2d 328. The SEC asserted that in reality, "Citigroup had arranged to include in the portfolio a substantial percentage of negatively projected assets and had then taken a short position in those very assets it had helped select." The SEC alleged that Citigroup realized net profits of approximately $160 million in connection with the

3. Please click here to read our discussion of Judge Rakoff's decision in the December 2011 edition of the Alert.

transaction, while the fund's investors suffered losses exceeding $700 million.

The same day that the SEC filed its complaint against Citigroup, the SEC presented a proposed consent judgment for the district court's approval. On November 28, 2011, Judge Rakoff denied approval on the grounds that "the proposed [c]onsent [j]udgment [was] neither fair, nor reasonable, nor adequate, nor in the public interest." Judge Rakoff found that the SEC's "long-standing policy … of allowing defendants to enter into [c]onsent [j]udgments without admitting or denying the underlying allegations, deprives the [c]ourt of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact."

Judge Rakoff also questioned the SEC's decision to charge Citigroup only with negligence, rather than scienter. He observed that "the combination of charging Citigroup only with negligence and then permitting Citigroup to settle without either admitting or denying the allegations deals a double blow to any assistance the defrauded investors might seek to derive from the [SEC] litigation in attempting to recoup their losses through private litigation, since private investors not only cannot bring securities claims based on negligence, but also cannot derive any collateral estoppel assistance from Citigroup's non-admission/non-denial of the [SEC]'s allegations."

The parties appealed.

Second Circuit Finds Judge Rakoff Applied an "Incorrect Legal Standard" in Reviewing the Proposed Citigroup Consent Judgment

On appeal, the Second Circuit held that Judge Rakoff had "abused [his] discretion by applying an incorrect legal standard" in reviewing the proposed Citigroup consent judgment. *Citigroup II*, 752 F.3d 285.

As an initial matter, the Second Circuit stated that "there is no basis in the law for [a] district court to require an admission of liability as a condition for approving" a consent decree. The Second Circuit underscored that "[t]he decision to require an admission of liability before entering into a consent decree rests squarely with the [SEC]." Because Judge Rakoff "did not condition [his] approval of the consent decree on an admission of liability," the Second Circuit found it unnecessary to "address the issue further."

The Second Circuit then turned to "the far thornier question of what deference [a] district court owes an agency seeking a consent decree." The Second Circuit held that "the proper standard" for a district court's review of a proposed consent judgment involving an enforcement agency is "whether the proposed consent decree is fair and reasonable." If the consent decree imposes injunctive relief, then district courts must also consider "the additional requirement that the 'public interest would not be disserved.'" The Second Circuit explained that "the district court is required to enter the order" unless there is "a substantial basis in the record for concluding that the proposed consent decree does not meet these requirements."

The Second Circuit stated that in "evaluating a proposed [SEC] consent decree for fairness and reasonableness," a district court "should, at a

minimum, assess" the following factors: (1) "the basic legality of the decree"; (2) "whether the terms of the decree, including its enforcement mechanism, are clear"; (3) "whether the consent decree reflects a resolution of the actual claims in the complaint"; and (4) "whether the consent decree is tainted by improper collusion or corruption of some kind."[4] The Second Circuit recognized that "depending on the decree a district court may need to make additional inquiry to ensure that the consent decree is fair and reasonable." However, the Second Circuit cautioned that "the primary focus" of any additional inquiry "should be on ensuring the consent decree is procedurally proper, using objective measures … [and] taking care not to infringe on the [SEC]'s discretionary authority to settle on a particular set of terms."

In the case before it, the Second Circuit found that Judge Rakoff had erred in requiring that the SEC "establish the 'truth' of the allegations against [Citigroup] as a condition for approving the [proposed] consent decree." The Second Circuit explained that while "[t]rials are primarily about the truth," "[c]onsent decrees are primarily about pragmatism" and "provide parties with a means to manage risk." The Second Circuit emphasized that "it is not within the district court's purview to demand 'cold, hard, solid facts,' … as to the truth of the allegations in the complaint as a condition for approving a consent decree." Moreover, a district court may not "reject a consent decree on the ground that it fails to provide collateral estoppel assistance to private litigants."

The Second Circuit further determined that Judge Rakoff had erroneously "defined the public interest as 'an overriding interest in knowing the truth.'" The Second Circuit directed that "[o]n remand, the district court should consider whether the public interest would be disserved by entry of the consent decree." A consent decree "may disserve the public interest" if, for example, "it bar[s] private litigants from pursuing their own claims independent of the relief obtained under the consent decree." However, a district court may not "find the public interest disserved based on its disagreement with the [SEC]'s decisions on discretionary matters of policy, such as deciding to settle without requiring an admission of liability." The Second Circuit emphasized that "[t]he job of determining whether [a] proposed [SEC] consent decree best serves the public interest … rests squarely with the [SEC], and its decision merits significant deference."

Finally, the Second Circuit found that "[t]o the extent [Judge Rakoff] withheld approval of the consent decree on the ground that [he] believed the [SEC] failed to bring the proper charges against Citigroup, that constituted an abuse of discretion." The Second Circuit stated that "[t]he exclusive right to choose which charges to levy against a defendant rests with the [SEC]."

The Second Circuit vacated Judge Rakoff's decision and remanded the action for further proceedings consistent with its opinion.

4. The Second Circuit pointed out that it had "omit[ted] 'adequacy' from the standard" of review. The court observed that "[t]he adequacy requirement makes perfect sense in the context of a class action settlement" because "a class action settlement typically precludes future claims." However, "a consent decree does not pose the same concerns regarding adequacy" because "if there are potential plaintiffs with a private right of action, those plaintiffs are free to bring their own actions."

Second Circuit Rejects Non-Settling Defendants' Challenge to a Settlement with Madoff Investors

On June 26, 2014, the Second Circuit dismissed for lack of standing a challenge by non-settling defendants PricewaterhouseCoopers and Citco to a class action settlement between Fairfield Greenwich Limited and Fairfield Greenwich (Bermuda) Ltd. (collectively, "Fairfield Greenwich") and investors in certain funds which were managed by Fairfield Greenwich and made investments with Madoff (the "FG Funds"). *Anwar v. Fairfield Greenwich Limited*, 2014 WL 2883924 (2d Cir. June 26, 2014) (Parker, J.).[5]

Background

Following the collapse of Bernard L. Madoff Investment Securities, investors in so-called "Madoff feeder funds" managed by Fairfield Greenwich filed a putative class action asserting federal securities and state common law claims against certain entities and individuals associated with Fairfield Greenwich (collectively, the "FG Defendants"); PricewaterhouseCoopers, the auditor of the FG Funds; and Citco and GlobeOp Financial Services, both of which provided fund administrative services to the FG funds. Fairfield Greenwich ultimately reached a settlement with plaintiffs.

Non-settling defendants PricewaterhouseCoopers and Citco (the "Non-Settling Defendants") objected to a provision in the settlement agreement providing that "investors who file claims under the settlement submit to the district court's jurisdiction for the sole purpose of participating in the settlement and not for any other purpose."[6] In the Non-Settling Defendants' view, "class members who submitted to the court's jurisdiction in order to accept the terms of the settlement could not, at the same time, be permitted to limit the legal consequences of doing so." The Non-Settling Defendants asserted that they "were entitled to argue that any entity that participated in the New York settlement could not pursue claims in any other jurisdiction."

In March 2013, over the objections of the Non-Settling Defendants, the Southern District of New York entered a final order approving the settlement and entered final judgment with respect to plaintiffs' claims against the FG Defendants (the "Final Order"). The Non-Settling Defendants appealed, contending that "the district court [had] erred in approving [the] provision [at issue] because district courts cannot permit litigants to agree to insulate themselves from personal jurisdiction if it would otherwise be created

5. Simpson Thacher represents certain entities and individuals associated with Fairfield Greenwich.

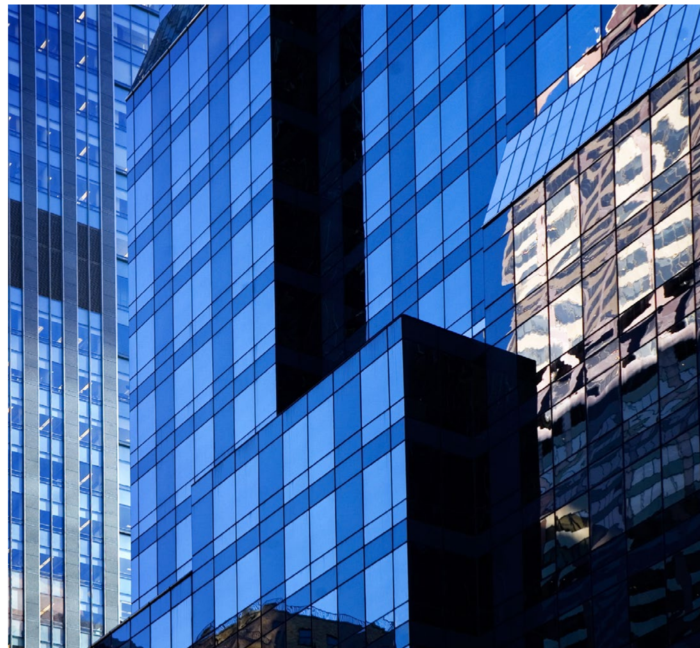
6. The provision at issue states as follows: "any Settlement Class Member who submits a Proof of Claim thereby submits to the jurisdiction of this Court with respect only to the subject matter of such Proof of Claim and all determinations made by this Court thereon and shall not be deemed to have submitted to the jurisdiction of this Court or of any court in the United States for any other matter on account of such submission."

as a result of the settlement." In response, plaintiffs argued, *inter alia*, that the Non-Settling Defendants had no standing to challenge the Final Order.

Second Circuit Finds the Non-Settling Defendants Lacked Standing to Challenge the Settlement Because It Did Not Eliminate Their Right to Assert Any Claims or Defenses

At the outset of its analysis, the Second Circuit explained that "a non-settling defendant generally lacks standing to object to a court order approving a partial settlement because a non-settling defendant is ordinarily not affected by such a settlement." The Second Circuit noted, however, that "there is a recognized exception to this general rule which permits a non-settling defendant to object where it can demonstrate that it will sustain some formal legal prejudice as a result of the settlement."

Here, the Non-Settling Defendants argued that "the Final Order causes them such prejudice because it 'effectively strips them of defenses against the settling plaintiffs in other fora, including defenses based on duplicative litigation and preclusion.'" The Second Circuit determined that "[t]his allegation … does not rise to the required level of formal legal prejudice necessary for standing." The Second Circuit ruled that "a settlement which does not prevent the later assertion of a non-settling party's claims (although it may spawn additional litigation to vindicate such claims), does not cause the non-settling party 'formal' legal prejudice." The Second Circuit explained that formal legal prejudice "exists only in those rare circumstances when, for example, the settlement agreement formally strips a non-settling party of a legal claim or cause of action, such as a cross-claim for contribution or indemnification, invalidates a non-settling party's contract rights, or [eliminates] the right to present relevant evidence at a trial."



The Second Circuit emphasized that "[n]othing in the Final Order precludes the Non-Settling Defendants from asserting in the district court or in other litigation any claims or defenses that may be available to them," including the argument that "participation in the settlement approved by the district court bars subsequent or parallel proceedings." The Second Circuit found it significant that the Non-Settling Defendants had "already invoked the 'preclusion defenses'" in parallel proceedings brought by plaintiffs in the Netherlands. The Second Circuit explained that this was "a significant demonstration that nothing in the Final Order prevents or limits them from continuing to assert that Settlement Class members' participation in the settlement bars, limits, or otherwise impacts claims against them in other jurisdictions."

For the foregoing reasons, the Second Circuit "conclud[ed] that the Non-Settling Defendants do not have standing to object to the settlement" and dismissed the Non-Settling Defendants' appeal.

Fifth Circuit Reverses Dismissal of a Securities Fraud Action Against Houston American Energy Corporation

On July 15, 2014, the Fifth Circuit reversed dismissal of a securities fraud action brought against Houston American Energy Corporation. *Spitzberg v. Houston American Energy Corp.*, 2014 WL 3442515 (5th Cir. July 15, 2014) (Davis, J.). The Fifth Circuit held that plaintiffs had "sufficiently pled circumstances constituting at least severe recklessness." Moreover, the Fifth Circuit found that the district court had erred by requiring plaintiffs to allege loss causation with particularity. The Fifth Circuit underscored that loss causation allegations are not subject to the heightened pleading requirements of the Private Securities Litigation Reform Act ("PSLRA").

Background

In April 2012, plaintiffs brought suit against Houston American Energy Corporation, two of the company's employees and several of the company's directors alleging misstatements in connection with an oil-and-gas concession under development in Columbia.

Plaintiffs took issue with defendants' November 2009 representation that one of the hydrocarbon blocks at the Columbia concession (the CPO 4 Block) had "estimated recoverable reserves of 1 to 4 billion barrels." According to plaintiffs, defendants' "use of the term, 'reserves,' communicated to investors that certain geological testing had been completed based on the definition of 'reserves' used by the oil industry and by SEC regulations." In reality, however, defendants conceded that "no actual production had occurred in connection with … [the] oil-and-gas concession in Columbia as of November 2009."

Plaintiffs also challenged defendants' claims in late 2011 and the beginning of 2012 that the "Tamandua #1" test well had yielded "strong inflow[s]" and "significant shows" of "gas and oil." Plaintiffs pointed to confidential witness testimony to the effect that "neither oil nor flowable hydrocarbons were found in the Tamandua #1 well" at the time of defendants' representations.

In early 2012, after a second round of well testing "revealed no flowable hydrocarbons," defendants decided to cease operations at Tamandua #1. "Upon disclosure that the well at Tamandua # 1 would be abandoned," the company's stock price "plummeted" by 35.5%.

On August 22, 2013, the Southern District of Texas dismissed the complaint for failure to allege scienter and loss causation. Plaintiffs appealed.

Fifth Circuit Finds Plaintiffs Adequately Alleged "Severe Recklessness"

On appeal, the court explained that the "required state of mind for scienter" can be established in the Fifth Circuit by "severe recklessness." The Fifth Circuit

noted that severe recklessness is "limited to those highly unreasonable omissions or misrepresentations that involve … an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."[7]

Here, the Fifth Circuit found that plaintiffs had met this standard. With respect to defendants' November 2009 statement concerning the CPO 4 Block's "reserves," the Fifth Circuit "assume[d] for the sake of argument that the industry-specific term, 'reserves,' would indeed communicate to investors that certain production or geological testing had already been conducted." The Fifth Circuit found that defendants' "use of this industry-specific term … undoubtedly present[ed] an 'obvious' danger of 'misleading buyers or sellers' of [the company's] securities as to the value of the company's assets."

The Fifth Circuit further found that defendants' "numerous representations regarding 'indications of oil' and 'strong inflow[s] of hydrocarbons'" at the Tamandua #1 well "may likewise have been obviously misleading to investors." The court explained that at the pleading stage, plaintiffs' "contention about the industry definitions of …" "terms such as … 'inflow' and 'indications of oil'" is "'at least as compelling as any opposing inference one could draw' regarding the likely understanding of these terms in this context." The Fifth Circuit concluded that plaintiffs' complaint therefore could not "be dismissed … based on the failure to plead severe recklessness."

Notably, the Fifth Circuit stated that "a strong inference of severe recklessness" does not turn on "the presence or absence of a pecuniary motive … to commit securities fraud." The court pointed out that in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), the Supreme Court stated that "[t]he absence of a motive allegation, though relevant, is not dispositive" under the PSLRA. In the case before it, the Fifth Circuit explained that "[e]ven if [defendants] were unable to benefit financially from their alleged misrepresentations, … such misrepresentations would still be severely reckless and dangerous to investors."

Finally, the Fifth Circuit found defendants' subjective belief immaterial to the scienter analysis. The court explained that "[w]hether [defendants] actually believed that oil could be found in the CPO 4 Block is irrelevant to whether [defendants] were severely reckless when they allegedly misled investors regarding previous geological testing in November 2009." Similarly, defendants' "subjective beliefs regarding the ultimate potential" for the Tamandua #1 well "are irrelevant to whether [defendants'] statements regarding 'indications of oil' and 'flowable hydrocarbons' were factually false and severely reckless in 2011 and 2012."

Fifth Circuit Holds Plaintiffs Need Not Plead Loss Causation with Particularity

The Fifth Circuit found that the district court had erred in dismissing the complaint for failure to allege loss causation with particularity. The Fifth Circuit explained that "the plain text of 15 U.S.C. § 78u-4(b)(4) does not indicate that it imposes any heightened standard, or make any mention of a 'particularity' requirement with respect to loss causation."[8] Moreover, the Fifth Circuit noted that in *Dura Pharmaceuticals,*

7. The Fifth Circuit noted that "the Supreme Court has explicitly refrained on several occasions from addressing whether allegations of recklessness are sufficient to satisfy the scienter requirement." However, the Fifth Circuit pointed out that in *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), the Supreme Court recognized that every circuit court to consider the issue "has held that a plaintiff may meet the scienter requirement by showing that the defendant acted … recklessly, though the Circuits differ on the degree of recklessness required."

8. 15 U.S.C. § 78u-4(b)(4) provides as follows: "In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

Inc. v. Broudo, 544 U.S. 336 (2005), "the Supreme Court explicitly declined to address whether any heightened pleading requirement applies to [loss causation]."

The Fifth Circuit stated that under its precedent, courts are "not authorized or required to determine whether the plaintiffs['] plausible inference of loss causation is equally or more plausible than other competing inferences, as [courts] must in assessing allegations of scienter under the PSLRA." While plaintiffs must "eventually" prove loss causation "by a preponderance of the evidence," the Fifth Circuit explained that "the PSLRA does not obligate a plaintiff to deny affirmatively that other factors affected the stock price in order to defeat a motion to dismiss."

Here, the Fifth Circuit found that plaintiffs had "sufficiently pled loss causation based on the drop in stock price that occurred after the abandonment of Tamandua #1." The Fifth Circuit reversed dismissal of plaintiffs' complaint and remanded the action for further proceedings consistent with its opinion.

Ninth Circuit Affirms Dismissal of a Securities Fraud Action against Intuitive Surgical

On July 16, 2014, the Ninth Circuit affirmed dismissal of a securities fraud action against Intuitive Surgical, finding that most of the misstatements at issue were either inactionable forward-looking statements or "garden variety corporate optimism." *Police Ret. Sys. of St. Louis v. Intuitive Surgical*, 2014 WL 3451566 (9th Cir. July 16, 2014) (McKeown, J.). The Ninth Circuit further held that plaintiffs had failed to meet the high bar for raising a strong inference of scienter under the core operations theory.

Background

Plaintiffs alleged that Intuitive Surgical and a number of its executives had "knowingly issued false and misleading statements regarding the company's growth and financial health, which caused artificial inflation of the share price" during the class period, "resulting in losses to the class members." Plaintiffs asserted that the company's executives "had access to adverse undisclosed information about the company's business, operations, [and] operational trends …" "by virtue of their positions with the company."

On May 22, 2012, the Northern District of California dismissed plaintiffs' complaint with prejudice for failure to state a claim. Plaintiffs appealed.

Ninth Circuit Finds the Alleged Misstatements Were Inactionable Forward-Looking Statements or Corporate Puffery

The Ninth Circuit found that "[t]he heart of [plaintiffs'] allegations … target [ed] misstatements]"

that were "not actionable because they [were] forward-looking statements covered by the safe harbor provision of the [Private Securities Litigation Reform Act] or mere corporate puffery."

The Ninth Circuit determined that the "alleged misstatements in [the company's] analyst calls [were] classic growth and revenue projections" that were "forward-looking on their face." The court explained that statements such as "we are now forecasting our system revenue to grow 45-46% over 2007 …" "are not 'misleading as to the then-present effects and circumstances,' of known trends on Intuitive's financial health." Rather, such statements "plainly project expectations for future growth." Moreover, the Ninth Circuit found that these forward-looking statements were accompanied by "sufficient" cautionary language warning that "[a]ctual results may differ materially from those expressed or implied, as a result of certain risks and uncertainties."

The Ninth Circuit also held that four of the alleged misstatements qualified as "mere corporate puffery." For example, "Intuitive communicated optimism … that the opportunity for system placement at hospitals '[was] still very, very large'" and represented "that the company [was] 'reservedly optimistic' about sales." The Ninth Circuit rejected plaintiffs' contention that "these pronouncements [were] objectively verifiable and thus qualif[ied] as material misstatements, not mere puffery." The court explained that these types of statements are "the antithesis of facts" and instead "represent the 'feel good' speak that characterizes 'non-actionable puffing.'"

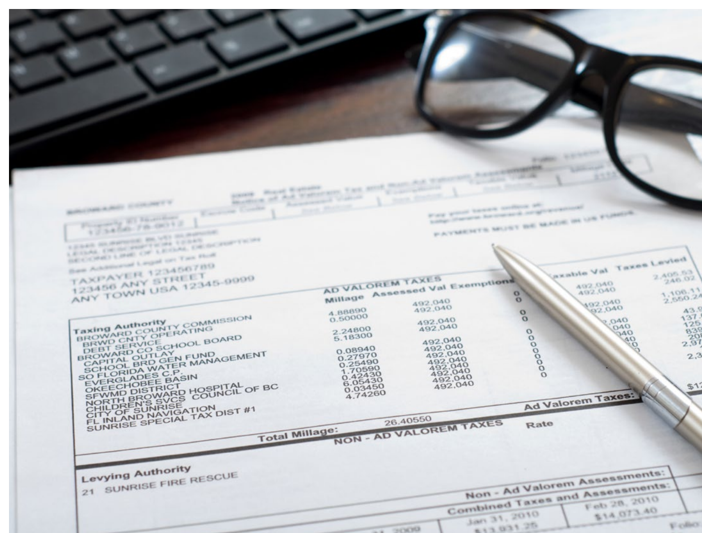
The Ninth Circuit acknowledged that "general statements of optimism, when taken in context, may form a basis for a securities fraud claim." However, the court underscored that "the context in which the statements were made is key." Here, the Ninth Circuit found that "'the market already knew' of the difficulties facing Intuitive" and thus, "any reasonable investor would have understood Intuitive's statements as mere corporate optimism."

Finally, the Ninth Circuit deemed irrelevant plaintiffs' argument that the "four statements [were] not puffery because they were *in fact* relied on by investors." The court explained that "[a]bsent an actionable misstatement, reliance does not come into play." "Theoretical reliance cannot transform corporate optimism into a securities violation."

Ninth Circuit Holds Plaintiffs Alleged No Actionable Omissions in Intuitive Surgical's 2007 Annual Report

The Ninth Circuit found meritless plaintiffs' claim that Intuitive's 2007 Annual Report "altered the 'total mix' of information available to investors by failing to disclose 'known trends.'" The court emphasized that "Rule 10b-5 prohibits '*only* misleading and untrue statements, not statements that are incomplete.'" The Ninth Circuit explained that it has "expressly declined to require a rule of completeness for securities disclosures because '[n]o matter how detailed and accurate disclosure statements are, there are likely to be additional details that could have been disclosed but were not.'"

The court stated that in order for an omission "[t]o be actionable under the securities laws, … it must affirmatively create an impression of a state of affairs



that differs in a material way from the one that actually exists." Here, the Ninth Circuit found that "[n]othing about the statements in the 2007 Annual Report would [have] give[n] a reasonable investor the impression that [Intuitive Surgical's] growth was different than it was in reality" and thus the report was "neither incomplete nor misleading."

Ninth Circuit Holds Plaintiffs Failed to Allege Scienter under the Core Operations Theory

Plaintiffs attempted to establish scienter based on the core operations theory, which assumes that "corporate officers have knowledge of the critical core operation of their companies." The Ninth Circuit explained that "[p]roof under this theory is not easy." To satisfy the demands of the core operations theory, "[a] plaintiff must produce either specific admissions by one or more corporate executives of detailed involvement in the minutia of a company's operations … or witness accounts demonstrating that executives had actual involvement in creating false reports."

Here, plaintiffs did not allege "specific admissions by the individual defendants regarding their involvement with Intuitive's operations or with the software-generated reports [at issue]." Plaintiffs instead "point[ed] to the impressions of witnesses who lacked direct access to the executives but claim[ed] that the executives were involved with Intuitive's day-to-day operations and were familiar with the contents of the software-generated reports because the substance of the reports was discussed in meetings."

The Ninth Circuit held that "[a]t best, these facts support a 'mere inference of [the defendants'] knowledge of all core operations,' not scienter." The court explained that there were no "allegations linking specific reports and their contents to the executives," nor did plaintiffs plead any "link between the witnesses and the executives." Moreover, the court determined that this was "not the 'rare circumstance' in which it would be 'absurd' to suggest that management was without knowledge of the contents of the reports" in question.

The Ninth Circuit concluded that plaintiffs had failed to "identify any material misstatements made with scienter," and therefore affirmed the district court's dismissal of the complaint with prejudice.

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